BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking on the Commission's Own Motion to Assess and Revise the Regulation of Telecommunications Utilities.	R.05-04-005 (Filed April 7, 2005)

REPLY COMMENTS OF THE OFFICE OF RATEPAYER ADVOCATES

REDACTED VERSION

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Pursuant to the Scoping Memo and Ruling of Assigned Commissioner and Administrative Law Judge, mailed August 4, 2005 (hereinafter, Scoping Memo), the Office of Ratepayer Advocates (ORA) submits these reply comments in response to the Phase 1 issues identified in Appendix A of the Order Instituting Rulemaking (OIR). We submit at this time both a redacted version, which contains public information only, and a completely proprietary version, containing individual and summary information proprietary to each of the four Respondents.[1] This proprietary version is submitted to the CPUC only at this time.

I. INTRODUCTION

A. "Just Right" Solutions for a Transitional Era

The OIR presented an open invitation to the proponents of deregulation, and many commenters (particularly the four Respondents) seized the opportunity. The advocates of near-total deregulation of intrastate telecommunications services attempt to equate the elimination of regulation with the promotion of competition and free markets. Yet, as the

[1] The OIR identifies Pacific Bell Telephone Company d/b/a SBC California (SBC-CA), Verizon California, Inc. (Verizon-CA), SureWest Telephone (SureWest) and Frontier Communications of California (Frontier) as Respondents. OIR, Appendix C.

authors of *Saving Capitalism from the Capitalists* warn, "[t]he absence of government can be anticompetitive and retard free markets."[2] Professors Rajan and Zingales, prominent University of Chicago financial economists and ardent defenders of free markets, explain:

> The Left is wrong in saying that markets need to be replaced by the government, for that will just perpetuate the capture by the elite. And the Right is wrong in saying we can dispense with the government. What we need therefore is a "Goldilocks" government—not too interventionist and not too laissez-faire, a government that is "just right." The difficulty with this Goldilocks position is, of course, in how to get the correct mix.[3]

In the comments that follow, ORA attempts to help the Commission find the "just right" mix of regulation and forbearance that will enable California consumers to reap the benefits of developments in telecommunications, while at the same time protecting consumers, businesses, and the California economy from exploitation by the still-dominant incumbent local exchange carriers (ILECs), which continue to exert considerable market power.

ORA will demonstrate, below, that each of the four largest California ILECs has erred in proposing a regulatory scheme that is too laissez-faire for the current and the predicted competitive environment in California. California consumers are most likely to thrive under a regulatory scheme that provides significantly increased pricing flexibility ***below*** existing price caps with streamlined, but effective monitoring of service quality and competition, and processes for swift action to remedy any situation that poses dangers to consumer interests.

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[2] Raghuram G. Rajan and Luigi Zingales, "Preface to the Paperback Edition," *Saving Capitalism from the Capitalists*, Princeton: Princeton University Press, 2004, p. x.

[3] *Ibid.*, p. xi.

B. Tailoring the Proceeding to the Issues

To make the analysis in this proceeding more efficient, ORA would like to address two substantive problems that might succumb to procedural solutions. First, the proprietary version of these reply comments ORA is filing with the CPUC cannot be made available to ***any*** of the other parties, unless and until parties have undertaken non-disclosure agreements (NDAs) with one another. ORA contends that advocacy efforts by parties such as ORA and TURN would be grossly overburdened were individualized and ILEC-specific proprietary submissions to be required. ORA suggests that the Administrative Law Judge (ALJ) direct the four ILECs to attempt to undertake such NDAs, and/or lawyers-only restrictions as may be necessary to make a single proprietary document useful and possible. ORA also asks that the ALJ issue an order eliminating any differentiation in treatment by the ILECs between TURN's compliance with the various NDAs and ORA's compliance with Section 583.

Second, ORA finds the timing and wording of the August 4, 2005 Scoping Memo somewhat ambiguous with regard to a number of important policy topics. As ORA believes the function of "reply" comments is to address opening proposals and comments made by other parties, ORA's submission at this time seeks to address specifically those points and proposals as fully as possible. Given that certain topics raised in the Scoping Memo were not addressed by parties in the opening round, it seems less than timely or complete to address them here in the midst of critiques of proposals and other responses.

ORA believes the important issues and questions raised in the Scoping Memo are so central and pivotal to California policymaking that they be given, at the very least, a full round of comments or, to be treated adequately, deferred to a subsequent full phase of this proceeding or another. These touchstone issues include but are not limited to the following: a definition of what constitutes basic local exchange service; what is "affordable"; where to draw a distinction between basic and non-basic service; what are the parameters of "high-quality" service; and which modern issues may be relevant to service quality today.

Other critical yet difficult issues raised by the August 4, 2005 Scoping Memo warrant review and analysis in a venue more substantial than an addendum to a set of reply comments. Attempting to set rules and regulation that achieve technological neutrality is a good example of this. Such a process suggests (variously) questions about the equal imposition of, or freedom from intrastate access and intercarrier compensation charges, surcharges and fees, and equal subsidies for Public Program services subject to subsidies. Similarly, the Scoping Memo excludes consideration of wholesale and interconnection issues, but fails to recognize the role of each in encouraging competition or in making competition possible. ORA suggests that this most recent set of intertwined issues, along with quality of service and basic questions of definitions and objectives, be deferred to another proceeding or to a subsequent phase of this proceeding.

II. EXECUTIVE SUMMARY

More than once, parties and other commenters have urged this Commission to "start from scratch" in this rulemaking, designing a telecommunications regulatory framework from the ground up, to ensure that regulation is oriented toward the future and not the past. ORA accepts the challenge of taking a fresh look at California telecommunications regulation, but rejects any suggestion that the Commission should ignore the experience of yesterday and today while planning for tomorrow. Instead, ORA recommends that the Commission rely on hard facts about existing and expected levels of competition in California and about the ways in which California's four largest incumbents have used the freedom from regulation they already have enjoyed.

Below, ORA summarizes evidence showing that, despite nearly a decade of assertions that competition in the telecommunications market "has arrived," the four largest California ILECs have suffered at most only relatively minor competitive losses for residential and business basic exchange services. Further, recent events demonstrate that the expected source of great competition "tomorrow" can become just another bankruptcy or acquisition when that tomorrow finally arrives.

Further, many of the "lost" access lines that SBC-CA and Verizon-CA claim as evidence of significant competition are lines for which they continue to be the wholesale provider of the underlying facilities (mostly in the form of the unbundled network element “platform” popularly known as UNE-P).[4] The incumbents are well-positioned to win back (or reacquire, through mergers) a significant portion of those “lost” lines.

The most recent available data indicate that SBC-CA and Verizon-CA may already have begun to reverse competitive line losses or at least are not losing ground to competition. Both companies join the mid-sized ILECs (SureWest and Frontier) in holding a near-monopoly share of facilities-based service to residential customers throughout most of their service territories. The CPUC should give greater weight to evidence that the current trend is toward reduced competition than to speculation about what may happen in the future.

In other cases, lines allegedly lost to competition are merely services that the incumbents have shifted to unregulated affiliates. For example, the ILECs’ reported residential line losses have consisted disproportionately of “secondary” or additional lines. Often, these lines have been “lost” to the ILECs’ own wireless and Digital Subscriber Line (DSL) affiliates, with little loss (or even a net gain) to the total corporate profits of the parent corporations that own SBC-CA, Verizon-CA, SureWest, and Frontier. It makes little sense to reward this cannibalization of regulated service offerings by lifting the price caps that ensure California consumers have at least one reasonably-priced choice for basic local services.

Contrary to their claims of suffering due to competition and unreasonable regulatory restraint, the California ILECs have flourished under the current regulatory framework. California consumers have not always been so fortunate. This Commission’s foray into price deregulation of inside wire maintenance plans, for example, already has helped the ILECs to undermine the existing price caps on basic residential local exchange services. As ORA explains in Sections V.D and VI.E below, both SBC-CA and Verizon-CA took advantage of the elimination of price regulation of inside wire maintenance plans to impose rapid and steep price increases that do not

[4] SureWest and Frontier have managed to avoid UNE-based competition almost entirely.

appear to reflect the underlying cost of service. The CPUC's imposition of a $2.99 per month price cap on these plans prevented further price increases, but not before the two largest ILECs had managed to obtain more than $2 per month in additional revenues from the substantial percentage of their residential customers who continue to subscribe to this service. Even at the current price cap, prices have increased several hundred percent for an allegedly "fully competitive" service.

These reply comments also document that SBC-CA has taken advantage of "Category 3" price deregulation under the current regulatory framework to impose significant price increases on business customers as well. Prices have increased by 358% for business inside wire maintenance plans, 152% for business message toll services (MTS)[5], 97% for "Custom 8" toll service, 14% for basic Centrex lines and 243% for basic Centrex features. Each and every one of these increases followed a CPUC decision determining that the service in question was subject to sufficient competitive pressures that the CPUC no longer needed to regulate the maximum prices charged.

The CPUC can expect similar price increases wherever it lifts price caps on the basic exchange services purchased by most residential and small business customers or on popular products that are tied to basic exchange service such as inside wire maintenance plans, basic MTS schedules and custom calling features. Indeed, it is virtually certain that at least SBC-CA will increase basic service rates at the first opportunity.

Competition may prevent significant price increases for customers who buy large "bundles" of services that include multiple vertical features, high-speed Internet services, wireless services and (perhaps) television services as well. Such customers with large spending on "communications services" overall present attractive targets for competition. But, the incumbents present no evidence concerning how many customers want or can afford the optional services in such bundles.

[5] On August 30, 2005, SBC-CA filed Advice Letter 27286 announcing new increases in prices for business MTS: a 17% rate hike for charges during the "Day" period and a 22% hike for "Evenings and Weekends." These increases are reflected in the percentages reported in the body of these comments.

Instead, in an effort to help subsidize lower prices for higher-end bundles where competition does exist, the incumbents will have every incentive to "nickel-and-dime" customers who just want or need to maintain their basic telephone service. Moreover, as we show below, there is some evidence that both SBC-CA and Verizon-CA are responding to competition for high-end bundles by channeling resources away from basic service customers and basic service quality. Thus, any balanced new framework should include monitoring to detect untoward effects on the California ratepayers that might otherwise be left behind.

Meanwhile, evidence concerning penetration rates nationwide shows that, for the first time in many years, a statistically significant decrease in telephone subscribership per household.[6] Unfortunately, California data exhibit the same recent downturn in universal service.[7] Important as it is to make advanced services available to diminish the "digital divide," it is equally important to maintain affordable prices for basic services so that the old-fashioned "telecom divide"does not grow wider and deeper. If the ILECs are granted upward pricing flexibility for primary residential access lines, the telecom divide will expand in California, thwarting the goal of universal service.

Customers who neither need nor want service bundles have little reason to hope that competition will force the ILECs to maintain prices for "Plain Old Telephone Service" (POTS) at or near current levels. Absent regulation, why would the ILECs keep their basic local exchange prices at current levels? UNE-P competition is being phased out, replaced by higher cost resale or "commercial agreement" arrangements that make it nearly impossible for wireline competitors to come close to matching the ILECs' current prices for basic exchange services. Cable and wireless competitors offer few, if any, basic telephony packages at prices comparable to the ILECs' current basic exchange

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[6] Alexander Belinfante, *Telephone Subscribership in the United States (Data through March 2005)*, Industry Analysis and Technology Division, Wireline Competition Bureau, Federal Communications Commission, rel. May 2005, p. 3. The data are collected in a manner that is intended to be neutral between wireline and wireless phones; thus, this result cannot be summarily dismissed as the result of wireless substitution. *Ibid.*, p. 2.

[7] *Ibid.*, pp. 20-21.

rates. Indeed, Comcast—the largest cable operator in California—has made clear that it intends to compete primarily on features and service, *not* on price. Stand-alone Voice over Internet Protocol (VoIP) services are available only to customers who also purchase a high-speed Internet connection, at a substantial additional cost.

Rural, low-income, and non-English-speaking customers may suffer the most if the Commission prematurely lifts price caps for basic exchange services. Competition for wireline basic exchange services appears to be less apparent in the less populous areas of the SBC-CA and Verizon-CA service territories (and throughout the relatively rural Frontier service territory). And, although competitors such as Telscape and Vycera have emerged to attempt to address the needs of non-English-speaking consumers, those competitors have made relatively small inroads into California intrastate telecommunications markets thus far and depend, at least in part, on UNEs obtained from the ILECs.

Business basic local exchange services are only slightly more competitive than residential basic exchange services. Even the largest businesses often rely on the single-line business services of the ILECs for, *e.g.*, fax lines and service to smaller branch offices. Small to medium-sized businesses are even more dependent on ILEC basic exchange services. ORA's analysis indicates that the four largest California incumbents already serve the vast majority of basic business lines in their service territories. The market shares of SBC-CA and Verizon-CA are likely to rise even higher if the pending mergers of SBC Communications Inc. (SBC) with AT&T Corp. (AT&T) and Verizon Communications Inc. (Verizon) with MCI Inc. (MCI) are approved. Significantly, these mergers also would place the two largest California ILECs in control of the companies that heretofore were the two most successful competitors for telecommunications services to the largest businesses—so-called "enterprise" customers. Thus, SBC-CA and Verizon-CA are poised to ***increase*** their market shares for services to the one group of customers for which they, arguably, have not been the dominant providers in recent years.

Nonetheless, the ILECs urge the Commission to ignore the current dismal state of competition in California and to focus instead on the alleged spurt of intermodal competition that has just surfaced and that, they claim, will accelerate dramatically in the near future. The "evidence" they offer to support these claims, however, is largely anecdotal or circumstantial. Moreover, as ORA explains below, the ILECs' claims concerning imminent competition are an instance of Yogi Berra's "déjà vu all over again." The ILECs have made remarkably similar claims in past attempts to justify relaxed regulation, yet California never seems to have turned the corner past which rampant competition awaited.

Notably, MCI (which in this proceeding echoes the ILECs' claims that intermodal competition is finally upon us, and is growing rapidly) took a very different position before both the CPUC and the FCC not long before its agreement to merge with Verizon was announced. The skepticism that the pre-merger MCI expressed concerning intermodal options seems equally well-founded today, based on the evidence that ORA has reviewed and discusses in detail in the comments that follow. Intermodal options such as wireless and stand-alone VoIP services generally serve as complements, rather than substitutes, for the ILECs' primary residential and basic business local exchange services. Further, wireless and VoIP options (or the broadband services over which VoIP is carried) may be provided by affiliates of the ILECs rather than true unaffiliated competitors. Only cable-based telephony appears to offer a meaningful challenge to the ILECs' hegemony and even then only in certain geographic areas, for residential customers buying service bundles and for a limited range of business customers.

Thus, contrary to the suggestion of some commenters that California has reached (or perhaps passed) some magic moment for near-complete deregulation of intrastate telecommunications services, ORA concludes that the moment has not arrived. Rather, the time is not yet right for lifting most existing price caps. This conclusion does not mean that ORA is mired in the past. Instead, ORA proposes a "just right" combination of the maximum downward pricing flexibility permitted under anti-trust laws, selective elimination of price caps for truly optional services such as secondary residential lines, continued price caps for basic services not currently subject to effective competition, and streamlined but effective monitoring of competition and service quality to determine whether and when the Commission should fine-tune today's "just right" framework to ensure that it meets tomorrow's market realities. To maintain regulatory balance (if not outright uniformity), ORA also urges the Commission to revamp universal service support and intercarrier compensation policies that unduly favor the ILECs at the expense of other competitors.

In Section III of these comments, ORA provides a more detailed description of its proposal. The sections that follow provide the analytical support for ORA's recommendation. Specifically, in Section IV, ORA explains that intermodal competition is not yet sufficient to constrain the ILECs' prices for most residential and business basic exchange services. In Sections V-VII, ORA reviews the evidence concerning competition in the SBC-CA, Verizon-CA and mid-sized ILEC (SureWest and Frontier) service territories today, applying the analytical framework described in ORA's opening comments and showing that the existing levels of competition in the markets for residential primary network access connections and basic business exchange services do not justify the regulatory freedoms sought by each of those incumbents. In Section VIII, ORA refutes the suggestion, made at the Commission's June 27, 2005 full panel hearing, that the time is right for near-total deregulation of California's intrastate telecommunications markets.

III. MAXIMUM DOWNWARD PRICING FLEXIBILITY PLUS REASONABLE PRICE CAPS AND STREAMLINED MONITORING EQUALS "JUST RIGHT" REGULATION

A. Pricing Flexibility

As explained in its May 31st comments, ORA believes that the degree of pricing flexibility granted for a particular service should reflect the extent to which competition effectively constrains the ability of the incumbents to exercise market power over that service. ORA's proposal for the pricing flexibility to be accorded to various services, therefore, reflects the evidence concerning competition summarized in the preceding section and presented in more detail in Sections V-VII below.

This evidence supports a distinction between essential residential primary line services, over which the incumbents appear to retain a substantial degree of market power, and secondary or additional line services, which are both optional and subject to a higher degree of competition than are primary line services. ORA proposes to retain price caps for primary lines, but not for secondary lines. Price caps also would apply to measured local usage, Zone Usage Measurement (ZUM), and Extended Area Services (EAS) whenever those services were used in conjunction with a primary line service, but not otherwise. Finally, to avoid *de facto* price increases for residential primary line services, ORA proposes to retain the current price caps for residential inside wire maintenance plans and certain vertical services.

The evidence summarized below also supports retention of price caps for basic single-line business services and the usage associated with those services. Regulating the price of access lines without regulating the price of associated usage would enable the incumbents to avoid any meaningful price constraints on basic exchange services. ORA's proposal also would retain price caps for PBX trunks, an essential input for the use of PBX systems as an alternative to the incumbents' Centrex/CentraNet offerings.

Price caps for all other retail services and for any bundle of services including at least one non-price-regulated service would be lifted. The Commission would forbear from imposing price regulation on new services, and the Respondents could establish prices for those services effective on a 1-day advice letter filing (although the Commission would retain the right to suspend incumbents' new service offerings thereafter for good cause if, *e.g.*, it were shown that the incumbent was attempted to deregulate a price-regulated service by disguising that services as a "new" service[8] or was failing to disclose in communications to customers that elements of a new bundled services are also available for purchase on an unbundled basis at capped prices).

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[8] *See* Opening comments of Cox California Telecom,LLC (U-5684-C), May 31, 2005 (hereinafter, "Cox Opening Comments"), 5/82/05, pp. 19 and 26.

Finally, given the incumbents' dominance over basic access lines, ORA's proposal also retains price caps for special access (which ORA understands will be addressed in Phase 2 of this proceeding) and for E911 services.

For each of the price-regulated services identified above, ORA proposes that prices be capped at current rates (including existing surcredits, if any) for three years. Price caps would be uniform statewide throughout each incumbent's service territory; however, the incumbents would be permitted to exercise downward pricing flexibility on a geographically deaveraged basis.

Price increases (where permitted) would be effective on 30-day advice letter filing and 25-day prior customer notice. Price decreases would be effective on 1-day advice letter filing. Contracts would become effective based on their own terms and conditions; the incumbents would be required to file contracts with the Commission within 15 days of their execution. Any required advice letter filings could be protested only for improper noticing or filing procedures, and no cost support would be required. Informational tariffs would continue to be filed for all intrastate regulated services.

ORA recommends eliminating Commission-established price floors for ***all*** services and all Commission-imposed restrictions on promotions, other than informational requirements. Correspondingly, ORA also proposes that the Commission make clear that no price, other than a price set at a Commission-regulated price ceiling, could be deemed to have been found lawful by the Commission.

ORA's opening comments explained the pitfalls of any Commission attempt to establish meaningful price floors in the current competitive environment. Absent a commitment to invest significant time and resources into establishing new price floors—and updating those price floors on a regular basis, Commission-imposed price floors are more likely to provide convenient excuses for the incumbents to seek price increases for near-monopoly services than they are to prevent below-cost pricing of competitive services.[9] Indeed, as discussed below, SBC-CA appears to be poised to do just that. If

[9] Even SBC-CA characterizes the existing price floor inflation mechanism as "dysfunctional." Borsodi Decl., 5/31/05, p. 21. Thus, if price floors are retained, ORA and SBC-CA agree that the existing price

competitors have a complaint concerning the incumbents' retail pricing, they should take that complaint directly to the courts and be allowed to make their case free from any pretense that the Commission has pre-determined economically meaningful price floors.[10]

During the third year of the period following initial implementation of this revised pricing regulation scheme, ORA recommends that the Commission review data concerning the evolution of competition since the inception of the modified regulatory framework and the manner in which the incumbents have exercised their relative freedom from price regulation. The results of this review would inform the Commission's decision as to whether any of the price caps should be lifted or adjusted at the end of the initial three-year period—or whether price caps need to be reinstituted for any of the services that had been given upward pricing flexibility.

B. Other Aspects of the Revised Regulatory Framework

1. Development of Competitively and Technologically Neutral Universal Service and Intercarrier Compensation Policies.

Under ORA's proposal, the Commission would retain at least two important roles in preventing anti-competitive behavior: (1) requiring the Respondents to provide intrastate-regulated ***wholesale*** services at just and reasonable prices, and on non-discriminatory terms and conditions; and (2) preventing the Respondents from shifting the costs of their competitive services onto customers who have few, if any, meaningful alternatives to the ILECs' services (*i.e.*, preventing cross-subsidization). A regulatory framework that combines rigorous wholesale regulation with effective controls on cross-subsidization would, in large part, eliminate the need for regulated limits on the Respondents' downward pricing flexibility and promotional offerings.

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floors would need to be scrapped and reset based on new studies.

[10] It is particularly important that the Commission make clear that it has in no way approved of the Respondents' prices should it adopt proposals such as SBC-CA's, in which Respondent contracts would be effective when signed, before the Commission is even furnished a copy, and are eventually filed with no cost support data making it impossible to determine the legality of the prices offered. Borsodi Decl., 5/31/05, pp. 27-28.

ORA's May 31st comments explained that the current intrastate universal service and intercarrier compensation policies favor some competitors over others and, in particular, foster anti-competitive behavior on the part of the incumbents.[11] Thus, to be effective in its two roles for preventing anti-competitive behavior, the CPUC must develop competitively neutral and technologically neutral California universal service support and intercarrier compensation mechanisms. It is particularly egregious for SBC-CA to seek eventual price deregulation of primary line residential basic exchange services for which it currently receives massive state subsidies designed to promote universal service.[12] ORA recommends that the CPUC address intercarrier compensation and universal service issues in Phase 2 of this OIR. Phase 2 also would be an appropriate forum in which to address other unequal regulations that favor the incumbents over new entrants, such as the concerns MCI raised regarding entry certifications requirements, California Environmental Quality Act (CEQA) review, and access to Rights of Way (ROW).[13]

2. Elimination of Earnings Regulation, Including Pass-Through of Gain on Sale.

ORA agrees in principle with the Respondents and some other parties that, to the extent not required by California regulations, California-specific "ratemaking" adjustments and the New Regulatory Framework (NRF) earnings-sharing mechanism would cease to exist under a revised regulatory framework. The CPUC would no longer

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[11] *See also* Opening Comments of MCI, Inc. in Response to Order Instituting Rulemaking for the Purpose of Assessing and revising the Regulation of Telecommunications Utilities, May 31, 2005 (hereinafter, "MCI Opening Comments"), pp. 18-22.

[12] *Cf.* Cox Opening Comments, pp. 16-17 and 26. *See* ORA's report, *Review of the California High Cost Fund B: A $500 Million Subsidy Program for Telephone Companies*, March 22, 2004, for a more complete discussion of the public policy issues raised by California's intrastate universal service support program.

[13] MCI Opening Comments, 5/31/05, pp. 9-14; *see also* Comments of the California Cable and Telecommunications Association, May 31, 2005 (hereinafter "CCTA Opening Comments"), p. 2 regarding CEQA. ORA notes that the issues MCI raises regarding mergers and acquisitions (MCI Opening Comments, 5/31/05, pp. 14-15) are outside the scope of this rulemaking.

require California-specific adjustments as part of earnings monitoring beyond those required to implement California statutes and regulations. For example, the CPUC could require simply “overlays” to standardized Uniform System of Accounts (USOA) reporting to identify the effect on earnings of the incumbents’ Yellow Pages and simple inside wire maintenance and repair operations. ORA recommends that the CPUC develop details of any California-specific earnings adjustments in workshops.

Under ORA’s proposal, shareholders would retain all gains on sale of assets, regardless of the type of asset or when it was purchased.

3. Development of Efficient, Targeted Monitoring and Auditing Requirements.

ORA also agrees in principle with the Respondents that many existing monitoring reports might be replaced largely by FCC ARMIS reports and supplemented with limited California-specific reports, to be determined in Phase 2. Parties should consider eliminating existing California-specific reports, with the goals of promoting competitive neutrality, avoiding duplication, and eliminating any remaining vestiges of cost-of-service regulation in mind. Parties should explore additional California-specific reports that will proactively monitor the presumption that intermodal competition is developing throughout California; these reports can be used to determine whether the modified regulatory framework is, in fact, achieving its objectives of providing “access to modern, affordable, and high quality service” for all Californians. Specifics of such new monitoring reports should be developed by parties in workshops, perhaps along the lines suggested in Appendix A to ORA’s May 31st comments. ORA recommends that reporting, monitoring, and audit requirements be addressed in Phase 2. These important requirements should be tailored to the general framework adopted, not discussed in a vacuum.

C. ORA's Proposal Is Superior to the Proposals of the Four Respondents

1. ORA's Proposal Better Matches the Degree of Pricing Flexibility to the Extent of Competition

As noted above and in ORA's opening comments, one desirable attribute of a regulatory framework is that it should match the degree of pricing flexibility to the extent of competition. ORA's proposal remedies flaws in the proposals of the four Respondents in this respect.

Table 1 compares ORA's proposal for pricing flexibility to those of the four Respondents to the OIR.

TABLE 1

	ORA	SBC-CA	Verizon-CA	SureWest	Frontier
Primary residential lines	Price-capped[14] at current levels for 3 years (renewable after review).	Price-capped at current levels “temporarily” until no later than June 1, 2007.	Price-capped at current levels for 3 years.	Price-regulated; no specific details.	Price-regulated; no specific details.
Additional residential lines	Flexibly priced.	Flexibly priced.	Price-capped at current levels for 3 years.	Flexibly priced.	Price-regulated; no specific details.
Residential measured usage, ZUM and EAS.	For primary lines, price-capped at current levels for 3 years (renewable after review); for additional lines, flexibly priced.	Flexibly priced (except for EAS lines used as primary residential lines, which would be capped until no later than June 1, 2007).	Flexibly priced.	Flexibly priced.	Flexibly priced.
Residential inside wire maintenance plans	Price-capped at current levels for 3 years (renewable after review).	Flexibly priced.	Flexibly priced.	Flexibly priced.	Flexibly priced.
E911	Price-capped at current levels for 3 years (renewable after review).	?	Price-capped at current levels for 3 years.	?	?
Single-line business services (1MB)	Price-capped at current levels for 3 years (renewable after review).	Flexibly priced.	Price-capped at current levels for 3 years.	Flexibly priced.	Flexibly priced.
PBX trunks	Price-capped at current levels for 3 years (renewable after review).	Flexibly priced.	Flexibly priced.	Flexibly priced.	Flexibly priced.
Special access	Price-capped at current levels for 3 years (renewable after review).	Flexibly priced.	Price-capped at current levels for 3 years.	?	?

[14] Whenever ORA’s proposal calls for price caps, those caps apply to both recurring and non-recurring charges. It does not appear that any of the ILEC proposals contemplate price caps for non-recurring charges.

These comparisons highlight some important distinctions between ORA's proposal and those of the Respondents.

- Unlike SBC-CA, which advocates only temporary price caps for primary residential lines terminating no later than June 2007, ORA proposes that price caps for these essential services continue for at least three years following adoption of a modified regulatory framework in this proceeding, and be renewable thereafter, depending on the outcome of the Commission's review of market conditions during the early years of this new program.

- Unlike Verizon-CA and Frontier, ORA proposes to eliminate price caps for secondary residential lines at the outset of the new program.

- Unlike SBC-CA and the mid-sized ILECs (but like Verizon-CA), ORA proposes to continue price caps for business basic local exchange services.

- Unlike Verizon-CA, ORA proposes to apply price caps for business local exchange services to PBX trunks and to the local usage charges associated with business basic exchange lines, rather than just to single-line measured business access lines (1MB) themselves.

- Unlike all four Respondents, ORA proposes to continue price caps for residential inside wire maintenance plans.

- Unlike SBC-CA (but like Verizon-CA), ORA proposes to continue price caps for special access services.[15]

At least two other important differences between ORA's proposal and those of the Respondents do not appear in Table 1.

- For all services remaining subject to price regulation, ORA proposes to cap both recurring monthly charges and non-recurring charges such as installation and service ordering charges. The Respondents do not explicitly address the treatment of non-recurring charges.

[15] The need for price caps on special access may be especially acute after March 12, 2006, when high-capacity loops and transport will cease to be available as unbundled network elements (UNEs) in several SBC-CA and Verizon-CA wire centers. XO notes that competitors may then become dependent on the ILECs' special access services and that the ILECs already have taken advantage of pricing flexibility for interstate special access services to impose significant rate increases for those services. Opening Comments of XO Communications Services, Inc., on the OIR and Phase 1 Issues, May 31, 2005, (hereinafter, "XO Opening Comments"), p. 5.

- Unlike Verizon-CA, but apparently like the other three ILECs, ORA proposes that the price caps for services remaining subject to price regulation be independent of one another. In contrast, Verizon-CA proposes to continue the "revenue neutrality" concept applied (albeit inconsistently) in the current NRF regime. Specifically, Verizon-CA proposes a "basket" approach in which the prices for price-regulated retail basic exchange services could be increased if there are offsetting decreases in the prices for price-regulated wholesale access services.

In each instance in which ORA's proposal differs from that of one or more of the Respondents, the ORA approach is superior. ORA's selection of services to remain subject to price caps best reflects the evidence concerning competition and market conditions summarized in the Executive Summary and presented in more detail below. In particular, ORA's proposal appropriately distinguishes between primary residential access lines and other residential services (including bundles of services). Both the evidence concerning intermodal options and the data concerning the ILECs' line losses to date suggest that residential customers have far more meaningful choices for secondary lines and bundles of services than they do for basic primary lines. Similarly, ORA's proposal to continue price caps for basic business local exchange lines recognizes that intermodal options are likely to be poor substitutes for these lines and that market concentration for basic business lines continues to be exceptionally high, indicating that the Respondents can exercise market power over the pricing of these services.

ORA's proposal also closes loopholes in the Respondents' proposals that could defeat the purpose of continuing price caps on basic exchange services. Exorbitant non-recurring charges for basic exchange services are just as anti-consumer as are excessive monthly recurring charges; indeed, regulators have long recognized that high non-recurring charges threaten universal service. Further, without price regulation of the local usage associated with measured-service basic exchange lines, a cap on the monthly charges for the line itself can become meaningless if local usage charges make the effective cost of using that line unaffordable. Similarly, insofar as consumers view services such as inside-wire maintenance plans an important (or even essential) adjunct to basic exchange services, increases in the price for those plans become in effect increases in the price for basic service. The sheer number of customers continuing to subscribe to the ILECs' inside-wire maintenance plans in the face of significant price increases suggests that many customers do, in fact, consider these plans to be part and parcel of the basic exchange service on which they depend. Thus, by continuing price caps for non-recurring charges, local usage, and residential inside-wire maintenance plans, ORA's proposal ensures that price caps for basic exchange lines themselves will be meaningful.

The same considerations apply to the distinctions between the ORA and Verizon-CA approaches to revenue neutrality. As ORA discussed at length in its opening comments, disparities in intercarrier compensation regimes account for some if not all of the recent success of intermodal options such as wireless and VoIP services. ORA anticipates reductions in intrastate access charges (above and beyond those currently under consideration in Phase II of R.03-08-018) to address these disparities. Verizon-CA's proposal would allow the company to fund these additional reductions in access charges by raising rates for residential and business local exchange services, which would eviscerate the price caps for those basic exchange services. ORA's proposal, in contrast, would ensure that the price caps for primary residential line and basic business line services are meaningful and are not subject to the discretionary choices of Verizon-CA to lower its prices for switched or special access.

2. ORA's Proposal Better Reflects the Uncertainties Regarding Future Levels of Competition

With the limited exception of Verizon-CA, the Respondents all push hard for the CPUC to make irrevocable decisions eliminating price regulation for most, if not all, ILEC services. ORA, in contrast, proposes that the remaining price caps be effective for three years and that they be renewable if the CPUC's review of roughly the two years' experience under the new proposal indicates a continuing need for price regulation of at least some intrastate telecommunications services.

Here again, ORA's proposal is superior to that of the three Respondents other than Verizon-CA. Change and uncertainty characterize telecommunications markets today. Much of the competition for basic exchange services in the recent past (and even today) has come from UNE-P, which is being phased out. Thus, despite the assertions of SBC-CA economist Dr. William E. Taylor[16], competitive market conditions in California today are not the same (and are in fact less favorable) than they were when the fCC, following the recommendation of the CPUC, granted SBC's Section 271 application based on the view that local markets were irrevocably open to competition. Dr. Taylor's notion that local markets in California are "contestable" based in part on access to allegedly below-cost UNEs[17] is equally out of line with current market conditions. It is unlikely that former UNE-P competitors will be able to maintain their market share (much less grow and flourish) under the higher-priced commercial arrangements that are taking the place of UNE-P. Indeed, the elimination of UNE-P appears to have been a driving force behind the decisions of AT&T and MCI to merge with SBC and Verizon, respectively.[18] (Dr. Taylor's opinion that the UNE and resale requirements of the 1996 Federal Telecommunications Act eliminated economic barriers to entry[19] likely would come as a shot to AT&T's lead witness in the SBC/AT&T merger proceeding. The witness testified in no uncertain terms that AT&T has irrevocably withdrawn from the mass market in lart part because the elimination of UNE-P made participation in that market uneconomic.[20] It is simply too soon to know how significantly the demise of UNE-P (and, if approved, the mergers of the largest ILECs with their former competitors) will affect competition for basic residential and business local exchange services in California.[21]

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[16] Comments of Dr. William E. Taylor in R.05-04-005, May 31, 2005 (hereinafter, "Taylor Decl."), p. 8.

[17] *Ibid*, p. 5.

[18] Comments of the United States Department of Defense and All Other Federal Executive Agencies, May 27, 2005 (hereinafter, "DOD/FEA Opening Comments"), pp. 2-3.

[19] Taylor Decl., 5/31/05, p. 17.

[20] A.05-02-027, Testimony of John Polumbo on Behalf of SBC Communications, Inc, and AT&T Corp., May 6, 2005, p. 5(A.9). ORA cites Mr. Polumbo's testimony here to show the contradictions between the positions taken by SC-CA in this rulemaking, through Dr. Taylor, and those that it is taking in the merger proceeding, as a joint applicant with AT&T, and not for the truth of the matter asserted.

[21] Verizon-CA declarant Dr. Debra J. Aron agrees that it is impossible to assess the future competitive significance of wireline competitive local exchange carriers (CLECs) based on data concerning their market penetration in the UNE-P era. Aron Decl., 5/31/05, ¶ 56.

Further, by the admissions of the Respondents and their consultants themselves, many of the sources of intermodal competition they cite as justification for price deregulation are still in the early stages of development and market penetration. Expected changes in the regulatory environment are likely to eliminate or substantially reduce artificial advantages available to intermodal competitors such as wireless and VoIP providers. For example, these providers have benefited from favorable intercarrier compensation regimes that allow them to pay far less to terminate calls on another carrier's network than the terminating access charges imposed on wireline carriers such as AT&T and MCI (or the Respondents, outside their ILEC service territories). Under industry pressure, however, the FCC and other regulatory bodies are beginning to take action to eliminate these disparities—and the artificial competitive advantage they convey. VoIP providers also must bear cost increases to comply with new E911[22] and wiretap requirements, which also will affect their ability to undercut the prices of wireline competitors that already bear these burdens.

ORA acknowledges that some of the new intermodal options (or others yet unknown) may prove to be as successful as the Respondents predict. As noted in the Executive Summary to these reply comments, however, the Respondents and their consultants have a track record of overestimating the future significance of new forms of competition. Therefore, even if the CPUC relies on such predictions to justify an experiment with further price deregulation, ORA urges the CPUC to build a review of the results of that experiment (and a possible reversal of direction) into any decision to increase the Respondents' pricing flexibility. ORA's proposal not only provides for such a review, it calls for upfront establishment of monitoring programs to collect the essential competition data upon which the review would necessarily depend.

D. ORA's Proposal Would Put California in Line with States that Are Adapting Regulation to Meet Changing Market Conditions

The Respondents make every effort to suggest that California has fallen woefully behind other, more "progressive" states that are rapidly deregulating intrastate

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[22] In the Matters of IP-Enabled Services and E911 Requirements for IP-Enabled Service Providers, WC Docket Nos. 04-36 and 05-196, *First Report and order and notice of Proposed Rulemaking* (FCC 05-116), rel. June 3, 2005, ¶ 1.

telecommunications services. The evidence they provide, however, suggests that few states have adopted deregulation as sweeping as the plans that the Respondents suggest for California. Most of the reform plans are just beginning to be implemented[23], and nearly all of them include price caps for basic residential and business local exchange services.[24]

ORA's proposal is in line with initiatives in other states that include price caps for these basic services and, if anything, provides more aggressive ***downward*** pricing flexibility than is available, or even under consideration, in most other jurisdictions. Thus, although ORA recommends that the CPUC tailor California regulations to state-specific conditions, ORA also notes that the CPUC need not fear it will be failing to "keep up with the Joneses" if it adopts ORA's proposal.

E. Summary

For all of the reasons discussed above, ORA believes that its proposal provides the Commission with the best possible balance of forbearance from interference in the operation of intrastate telecommunications markets with regulatory intervention to protect consumers (and competition) where market forces are not yet sufficient to accomplish those ends. ORA therefore recommends that the Commission adopt its proposal, rather than any of the Respondents' proposals.

IV. INTERMODAL COMPETITION DOES NOT JUSTIFY ELIMINATING PRICE CAPS FOR PRIMARY RESIDENTIAL LINES OR BASIC BUSINESS EXCHANGE LINES.

All four Respondents rely heavily on alleged intermodal competition to justify their requests for increased regulatory flexibility, but the evidence they provide is largely circumstantial or anecdotal. ORA's May 31st comments provided an overview of the many reasons that the Commission cannot yet rely on intermodal competition to prevent the major

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[23] The relative recency of these plans—and the fact that many of them have yet to go into effect—precludes any meaningful analysis of the impact on consumers in states that have adopted some form of deregulation. Thus, ORA cautions against relying on the mere existence of relaxed regulation elsewhere as evidence that such an approach would be desirable in California.

[24] *See, for example,* Aron Decl., 5/31/05, Attachment DJA-2.

California ILECs from abusing their market power. In these reply comments, ORA focuses on the inability of intermodal competition to prevent excessive pricing of primary residential lines (other than those obtained as part of a large "bundle" of services) and basic business exchange lines.

As ORA demonstrates below, the Respondents' discussion of intermodal competition tends to treat competition for secondary residential lines and bundled services as if it were evidence of more widespread competition and thereby exaggerates the degree to which intermodal competition justifies price deregulation. A careful examination of the available evidence shows the dangers of such an unfocused discussion.

Intermodal options that may be acceptable as secondary lines are not always reasonably close substitutes for *primary* network access connections. The primary network access connection is many customers' lifeline to the world. Other residential customers do buy additional telecommunications services, but the tradeoffs they are willing to make between price and service quality/reliability may differ substantially between primary network access connections and all other services. The primary line to a household is the means for making 911 emergency calls and for making and receiving other important calls during power outages, natural disasters and other situations in which the virtual certainty of being able to complete a call over a clear connection is extremely valuable. Even in less critical situations, it is likely that a family will care far more that at least one access line—the primary network access connection—provides reliable service than that additional lines for teenagers, home fax machines, *etc.*, are providing comparable reliability.

Thus, it is a matter of real public policy concern that intermodal competitors target residential customers who buy high-priced service bundles, rather than the quintessential "little old lady" on a fixed income who wants only reliable POTS local and long-distance service over a primary line with few, if any, vertical features. Intermodal competitors are unlikely to target the more than 2.8 million California lifeline customers served by SBC-CA and Verizon-CA alone in 2004[25] or to reach out to consumers in California's more rural and less affluent

[25] ARMIS 43-08 data from Table III, "Residential Switched Access Lines – Lifeline."

areas. Even many small businesses may find intermodal options to their ILEC's wireline basic exchange service undesirable—or entirely unavailable.

Also, as ORA pointed out in its opening comments, the Respondents themselves are affiliated with some of the largest intermodal "competitors," including the two largest wireless carriers Cingular (an SBC-CA affiliate) and Verizon Wireless (a Verizon-CA affiliate). Verizon also has a nascent VoIP offering. *****BEGIN VERIZON CONFIDENTIAL END CONFIDENTIAL*****[26], there is little reason to expect that Verizon's VoIP offering will have less-than-typical success. Indeed, Verizon has the advantage of controlling the broadband facilities over which its in-territory VoIP offering would be provided, an advantage that only its cable-based competitors can match.

Similarly, all four Respondents (or their affiliates) provide significant numbers of DSL lines and thus control one of the primary options by which "pure-play" VoIP providers can reach customers. Also, from a wholesale perspective, regardless of whether the customer's wireless calls are local or long-distance calls, an excellent chance exists that some part of the call actually will be carried on the Respondents' networks; thus, wireless competition is not entirely a substitute for wireline services. The same observation applies to "competition" from sources such as email and instant messaging. These new forms of competition also tend to rely on the Respondents' networks and are merely more new sources of income for the Respondents as a whole.[27] The Respondents do not deny that these services often travel, at least in part, over their facilities; they claim, however, to be unable to determine what portion of the facilities used to deliver such services they control. Thus, such communications can hardly be considered competition.[28] Even cable companies (the prototypical "facilities-based" competitors) may rely, at least in part, on assets the incumbents control or may soon control.[29]

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[26] Verizon-CA Response to ORA Request 5-6.

[27] *E.g.*, SBC-CA Responses to ORA 4-7 and 4-8; A.05-02-027, SBC Response to TURN 6-13 to 6-15; A.05-04-020, Verizon Responses to TURN Requests 3-76 and 3-77.

[28] *Ibid.*

[29] *E.g.*, it appears that MCI currently provides support for Time Warner's digital phone service as described at: http://www.timewarnercable.com/InvestorRelations/PressReleases/TWCPressReleaseDetail.ashx?PRID=3&Mar

A. Wireless Service Is More Often a Complement to, Rather than a Substitute for, Wireline Local Exchange Services

The Respondents cite competition from wireless services as one of the major competitive threats justifying additional regulatory freedoms for their wireline local exchange services. Much of their "evidence" is merely circumstantial. For example, Verizon-CA declarant, Dr. Aron, cobbles together data from two entirely different surveys that are not necessarily comparable (and are subject to sampling error) to infer a rate of increase in wireless substitution for wireline phones between the "first half of 2003" and February 2004. She then compares this entirely speculative increase in wireless substitution to an "actual" loss of landline phone lines that is *actually* a "linear interpolation" from real data about the number of ILEC and CLEC landline phones nationally). The result, reported in Table 3 of her declaration, is an exercise in creative writing that concludes—without a shred of real proof—that wireless substitution "explains" 60% of the (entirely hypothetical) loss of landlines[30] and that it is inflicting major pain (and consequently providing significant price discipline) for the ILECs' basic exchange operations.[31]

Dr. Aron's analysis, like other circumstantial analyses of wireless substitution, is neither conclusive nor entirely consistent with other well-established facts. Wireless services substitute for primary wireline connections only when customers completely "cut the cord" and have no wireline connection into their homes. Although it is true that the number of wireless phones in California has increased dramatically, this increase has not been accompanied by anything remotely approaching a comparable decrease in the number of wireline phone connections. Thus, it is clear that most consumers obtain wireless phones in addition to, rather than instead of, wireline phones.

This makes complete sense because a wireline phone is location-specific and is available to anyone present at that location, whereas most wireless phones are described as

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ketID=0. Also see, MCI response to ORA 1-1.

[30] Aron Decl., 5/31/05, Table 3 and ¶¶ 65-66.

[31] *Ibid.*, ¶ 69.

mobile phones for a reason—when the wireless subscriber is away from the subscriber's residence or place of business, the wireless phone is not available for use by others remaining at that location. It is no wonder that the number of wireless phones to which multi-person households (or businesses) subscribe has proliferated at the same time that the number of location-specific wireline phones has held fairly constant. The existence of multiple wireless phones may substitute for "teen phones"—once a popular motivation for adding a second wireline phone to a household—but that does not imply any significant diminution in the demand for *primary* wireline connections.[32]

ORA acknowledges that there is some wireless substitution for primary wireline phone connections. As ORA explained in its opening comments, however, customers who are willing to "cut the cord" entirely tend to be younger customers, many of whom may be in single-person "households." The needs of these customers are quite different from those of customers who are unwilling to make that switch.

An analyst on whom Verizon relies concluded that there is a *****BEGIN VERIZON FCC HIGHLY CONFIDENTIAL (SUBJECT TO SECOND PROTECTIVE ORDER)** [33] **END CONFIDENTIAL***** on wireless substitution.[34] This conclusion is not surprising in light of evidence reviewed by the FCC indicating that "most consumers may still find the costs (including opportunity costs) of cutting the cord and using wireless telecommunications services in lieu of wireline telecommunications services to be prohibitive."[35] The FCC found

[32] Indeed, one of the few econometric studies indicating that wireless phones are substituting for wireline connections in the United States concluded that wireless services are a substitute for *secondary* fixed lines, but made no such finding with respect to primary lines. Rodini, Ward and Woroch., "Going Mobile: Substitutability between Fixed and Mobile Access," December 2002, p. 2.

[33] The "Second Protective Order" referenced is an order in the FCC's Verizon/MCI merger proceeding. In A.05-04-020, ORA obtained access to documents filed by Verizon in the FCC merger proceeding and has obtained permission from Verizon-CA to use those documents in this rulemaking subject to the same degree of protection originally afforded to the documents.

[34] A.05-04-020, Verizon FCC production, Industry and Competitive Environment Update, 9/10/04, VZCA 00316155, at VZCA 00316186, Verizon permission to use granted in response to ORA 6-1.

[35] In the Matter of Applications of AT&T Wireless Services, Inc. and Cingular Wireless Corporation For Consent to Transfer Control of Licenses and Authorizations File Nos. 0001656065, *et al.* WT Docket No. 04-70; and Applications of Subsidiaries of T-Mobile USA, Inc. and Subsidiaries of Cingular Wireless Corporation for

that there is a "… limited level of wireless-wireline competition at this point in time,"[36] and "a relatively limited number of mass market consumers have chosen to substitute one service [wireless] for the other [wireline]."[37]

Even if some customers treat their cell phones as their "primary" lines for making and receiving local and/or long-distance calls[38], that is substitution for *usage* not primary access lines if the customer still has a landline phone. Not only is usage substitution irrelevant to the market for primary access lines, it is of less significance in general. Consider the example of a residential customer who subscribes to one of the Respondents' flat-rated local exchange service (the typical choice) and to wireless service. If that customer uses his wireless phone rather than his land line to make and receive local calls, the incumbent does not lose a penny—the customer's bill for local exchange service remains unchanged (and the company may even avoid some switching and transport cost).[39]

Verizon, SBC and BellSouth together control some 63% of the major national wireless service providers, and may individually control a disproportionately larger share within their respective wireline service footprints, in part as a result of "bundling" wireless with wireline. SBC-CA's market share surveys suggest that SBC and Verizon alone provided as much as

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Consent to Assignment and Long-Term *De Facto* Lease of Licenses File Nos. 0001771442, 0001757186, and 0001757204 WT Docket No. 04-254; and Applications of Triton PCS License Company, LLC, MCI Wireless PCS, LLC, and Lafayette Communications Company, LLC For Consent to Assignment of Licenses File Nos. 0001808915, 0001810164, 0001810683, and 50013CWAA04 WT Docket No. 04-323, Memorandum Opinion and Order, October 26, 2004, ¶ 241, footnotes omitted (hereinafter, "Cingular/AT&T Wireless Order"). Among the costs to the consumer cited by the FCC are "the loss of an option to access the Internet via broadband or dial-up, possible effects on his credit rating, or inexpensive access to a home security system." *Ibid.*

[36] *Ibid.*, ¶ 238.

[37] *Ibid.*, ¶ 239.

[38] As ORA explained above and in its opening comments, wireless carriers' ability to offer "free" long distance calling stems from certain pecuniary distortions created by FCC regulations, and not from any production efficiency or technological advantage. A unique regulatory treatment allows wireless carriers to avoid paying access charges in many cases where a wireline long distance carrier would incur these charges. Because their access charge burden is significantly lower than that confronting wireline carriers (and because they charge for airtime usage), wireless providers often do not assess a discrete charge for long distance calls, which artificially stimulates usage substitution.

[39] *E.g.*, SBC-CA Response to ORA 10-5.

*****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL***** of small business wireless service in SBC's service areas in California as of February 2005.[40] All wireless carriers make extensive use of ILEC special access services to interconnect their transceiver sites with the wireless carrier's Mobile Telephone Switching Office (MTSO); thus, at least a portion of any wireline revenues "lost" to nonaffiliated wireless carriers will also come back to the major ILECs in the form of additional special access services required by the wireless carrier to meet the additional demand. For this reason, even an actual "loss" of a wireline customer to wireless – in the rare instances where that may occur – in most instances is not a complete loss of the customer to the Respondents (with the possible exception of Frontier).

Further, as the FCC has concluded, wireless affiliates of wireline ILECs are likely to go out of their way to avoid direct competition with their wireline brethren. Joint marketing of wireless and wireline services, rather than head-to-head competition, is the rule of the day. For example, Verizon promotes its "Verizon Plus" stores, where "customers can purchase telephone equipment, wired and wireless services or pay home phone and Verizon Wireless bills."[41]

Another recent offering by Cingular and its ILEC affiliates (SBC and BellSouth) demonstrates the continued demand for wireline phones for emergencies and for incoming calls. With Cingular's new "FastForward" service, wireless customers whose local wireline provider is either SBC or BellSouth can place their wireless phone in a special cradle, which then signals Cingular to automatically forward all incoming cell phone calls to the customer's wireline home phone. Under this arrangement, which SBC and Cingular describe as "integration" of wireless and wireline service, the customer does not incur a charge for air time usage on the forwarded call.[42]

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[40] SBC-CA Response to ORA 2-5, Consumer and Small business surveys.

[41] Verizon News Release, "Verizon Invites Texas, Florida Customers to Cut the Cable and Integrate Calling, Internet and DIRECTV Programming," March 29, 2004, available at http://newscenter.verizon.com/proactive/newsroom/release.vtml?id=84353 (accessed August 12, 2005).

[42] http://www02.sbc.com/Products_Services/Residential/ProdInfo_1/1,,1349--1-3-21,00.html

All of the information above suggests that the Respondents' evidence concerning wireless substitution at most justifies additional pricing flexibility for residential services other than primary access lines. Indeed, the Respondents' evidence rarely addresses intermodal competition from wireless services for *business* services at all. In a data response relating to her testimony in the SBC-AT&T merger proceeding (which closely tracks her declaration on behalf of Verizon-CA in this proceeding), Dr. Aron conceded that wireless phones are not a close substitute for wireline phones for most small businesses (other than, *e.g.*, plumbers and other trades persons who spend a large portion of their working day away from their business premises).[43] Thus, the CPUC simply has no basis to authorize upward pricing flexibility for primary residential lines or business access lines based on intermodal competition from wireless services.

B. With the Limited Exception of the Cox Service Territory, Cable Telephony Is Still in its Infancy in Most of California

One of the catalysts for the 1996 Act was the promise, or at least the potential, that monopoly cable operators and monopoly ILECs would enter each other's business. Cable providers had been flirting with telephony for a number of years; indeed, it was the prospect of cable bypassing the ILEC bottleneck and serving as the second wire into the home that prompted AT&T's disastrous foray into cable TV in 2000.

At least in theory, however, cable-based telephony services can serve as substitutes for residential primary network access connections, although some cable-based offerings may not provide the service quality and other attributes that consumers require for their primary connection. (For example, E911 access is an important attribute of primary network access connections. Even in the best of circumstances, E911 is more complicated for VOIP providers to provision than it is for wireline service providers. At present E911 for VoIP depends at least to some degree on the customer self-reporting—and updating—the location at which he or she currently is taking service.[44])

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[43] A.05-02-027, SBC Response to TURN 11-41.

[44] FCC VOIP E911 Order, Rel. 6/3/05, ¶ 2.

Although cable telephony has been touted as having great competitive promise, that potential has been slow to develop. By year end 2004, cable systems were providing basic local telephone service to only about 3.71-million customers nationwide.[45]

This slow roll-out is not surprising. It is a costly undertaking to upgrade cable systems from their traditional one-way analog video distribution capability to a network architecture capable of supporting digital video and two-way services such as high-speed Internet access and circuit-switched voice telephony. Nationally, cable passes approximately 107-million homes[46], but not all of these facilities are telephony-capable, making cable less ubiquitously available than wireline telephone service. Of the 107-million homes passed, only about 61% currently subscribe to cable TV service.[47] Thus, even after many years of development and massive investments, the 3.71-million cable telephony subscribers represent only 3.5% of all homes passed by cable, 5.7% of all cable TV subscribers, and approximately 2% of all local telephone access lines.

Moreover, it is not at all certain that cable telephony will act to constrain ILEC prices and market power for primary residential access lines. Cable TV operators such as Comcast, Cox, and Time Warner are not required to make components of their networks available to potential competitors or even to allow competitors to use their facilities on a bundled resale basis. Thus, while cable TV companies compete with the incumbent LECs on a retail basis, they are not a source of wholesale competition for access to facilities into the home. Absent a requirement to make their facilities available on a wholesale basis, cable telephony competition by itself might some day result in a duopoly market. Duopoly markets in which two firms carve up all of the demand between them may look much like monopoly, rather than competitive, markets, in that the duopolists are likely to charge prices above marginal cost.[48]

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[45] FCC Industry Analysis and Technology Division, *Local Telephone Competition: Status as of December 31, 2004*, rel. July 2005, at Table 5.

[46] Federal Communications Commission, Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, MB Docket No. 04-227, Eleventh Annual Report, rel. February 4, 2005.

[47] *Ibid.*

[48] W. Kip Viscusi *et al.*, *Economics of Regulation and Antitrust*, 2nd Ed. MIT Press, 1998, at 81.

Thus, if cable is the only actual competitor to the ILECs for basic local telephone service, its presence may not have any material effect in constraining ILEC prices and market power over "last mile" facilities.[49]

The Respondents rely heavily on generic, nationwide pronouncements concerning potential competition from cable companies.[50] Nationwide data can provide some sense of broad trends and technological capabilities, but they are not always representative of conditions in the service territories of the four major California ILECs. For example, on a nationwide basis, Verizon's data indicate that *****BEGIN VERIZON FCC HIGHLY CONFIDENTIAL (SUBJECT TO SECOND PROTECTIVE ORDER) AND "LAWYERS ONLY" CONFIDENTIAL** [51] **END CONFIDENTIAL***** which may or may not relate to conditions in its California service territory. Indeed, the cable company that predominates in the Verizon California service territory (Adelphia, whose California assets are being acquired by TimeWarner)[52] is different from the ones that predominate in *****BEGIN VERIZON FCC HIGHLY CONFIDENTIAL (SUBJECT TO SECOND PROTECTIVE ORDER) AND "LAWYERS ONLY" CONFIDENTIAL** [53] **END CONFIDENTIAL*****

Knowing which cable competitor is present in a particular geographic area is important because each cable company has a somewhat different competitive strategy, which must be considered in the competitive analysis. For example, in the concurrent Verizon/MCI merger proceeding (A.05-04-020), Dr. Rubinfeld (also a director at LECG, LLC along with Dr. Aron and Dr. Harris), provides analysis on behalf of Verizon which shows that only 4% of

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[49] DOD/FEA Opening comments, 5/27/05, p. 6 ("In the meantime, the mass market for telecommunications will be characterized by a duopoloy consisting of ILECs and cable companies. While duopolies provide a choice to customers, they do not create an effective restraint on prices".)

[50] *E.g.*, Aron Decl., 5/31/05, pp. 44-49; Harris Decl., 5/31/05, pp. 26-29.

[51] A.05-04-020, Verizon FCC Production, VZCA 00316510, at VZCA 00316534.

[52] A.05-04-020, Joint Reply of Verizon Communications Inc. and MCI, Inc., 6/6/05, p. 32.

[53] A.05-04-020, Verizon FCC Production, VZCA 00316510, at VZCA 00316534.

Adelphia's cable subscribers in California are served by telephony-ready plant, far below the 36% statewide average.[54]

In fact, with the exception of Cox (discussed below) cable competition for basic telephone services in California is still largely a question of future potential, rather than current significance. Comcast, the major cable operator in SBC California's service area, has been in a holding pattern as it prepares to roll-out VoIP services. Comcast plans to focus on offering fairly high-quality services without competing aggressively on price.[55] This strategy may make its services more acceptable as primary line substitutes, but it is unclear whether Comcast will be able to win a substantial market share over the next few years. Even *****BEGIN SBC "LAWYERS ONLY" CONFIDENTIAL** [56] [57] [58]

[59] [60] [61] **END CONFIDENTIAL*****

If in fact Comcast follows through with its stated intention not to compete on price, it is uncertain how much success it will have in the residential market in the SBC-CA territory. *****BEGIN SBC-CA CONFIDENTIAL** [62] **END CONFIDENTIAL*****

[54] A.05-04-020, Rubinfeld Decl., 4/21/05, Table 1, p. 21.

[55] Ryan Kim, "SBC and Comcast Want It All: Telecom Giants in Rush to Offer Phone, Net, TV Combo Deal," *San Francisco Chronicle*, July 31, 2005.

[56] A.05-02-027, Exhibit 91-C, SBC-CA "LAWYERS ONLY" CONFIDENTIAL, hereinafter "Changing the Game with Voice" 4/4/05, at pp. 5 and 9. SBC-CA permission to use with redactions provided by letter from Paul P. Strange to Helen Mickiewicz, dated August 29, 2005.

[57] *Ibid.*, at p. 12.

[58] *Ibid.*,at p. 13. Another analysis, which Dr. Aron relied on in her testimony on behalf of SBC in its Application to acquire AT&T but has dropped from her current analysis on the same topic in this docket, projects that cable VoIP could achieve penetration levels of up to 17% by 2010. A.05-02-027, Attachment to TURN 7-44, p. 014769.

[59] *Ibid.*, p. 3.

[60] *Ibid.*, pp. 17-23.

[61] *Ibid.*, p. 26

[62] SBC-CA Response to ORA 10-9. *e.g.*, December Report at RROIR 014442.

Moreover, in the SBC/AT&T merger proceeding, Dr. Aron admitted that Comcast does not currently even offer basic telephone service to business in California and has no known plans to do so within the next two years.[63] Hence, it is far from certain that SBC-CA will face any significant competition in the near future from cable providers other than Cox (with its relatively limited geographic scope) or if any such competition will effectively constrain SBC-CA's pricing of basic residential and business local exchange services.

Cox has been offering service in California for five years and considers its telecommunications product "mature."[64] Thus, there is little reason to expect Cox's market share for telephony services to increase dramatically in the next few years. Further, while SBC-CA and Verizon-CA customers who live in areas served by Cox may indeed have a second option for "wired" home service today, residents down the road who are served by a different cable company may not have the same options now or for years to come.

ORA also notes that SBC-CA's analysis of its lost residential customers suggests that *****BEGIN SBC-CA CONFIDENTIAL** [65] [66] [67] **END CONFIDENTIAL***** Thus, where competition does develop, it may not be competition for all types of customers, particularly with respect to those in lower income brackets.

C. "Pure-Play" Stand-AloneVoIP Providers Provide Only Limited Competition for the California ILECs

The incumbents blur together expected future competition from cable companies using VoIP with competition from "pure-play" VoIP providers such as Vonage, Packet8 and Skype.[68]

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[63] SBC-CA Responses to ORA 9-19 and 9-20.

[64] Aron Decl., 5/31/05, p. 44.

[65] SBC-CA Response to ORA 10-9. Due to the volume of this material and because it was only supplied in paper format, ORA is not supplying complete copies of all twelve monthly reports in Exhibit 1 to its reply. However, ORA is providing its summary of the top five competitors from the SBC studies for each month and a complete copy of the most recent SBC survey result that SBC provided, which is for December 2004.

[66] SBC-CA Response to ORA 10-9, December 2004 Survey, at RROIR 014445.

[67] *Ibid.*

[68] Aron Decl., 5/31/05, pp. 42-62 (*e.g.*, pp. 49-50); Harris Decl., 5/31/05, pp. 25-28.

This creates a totally false impression about the extent of competition that the incumbents face from VoIP providers.

"Pure-play" VoIP providers such as Vonage do not provide their own physical connection to end-user customers, but instead require that customers maintain a broadband connection typically supplied by either cable company facilities or the incumbents' wireline DSL facilities. Hence, pure-play VoIP is not actually a competitive alternative for bottleneck local exchange facilities at all. It is instead essentially an alternate means of obtaining toll calling and vertical features for customers with broadband service.[69] Further, as Cox explains in detail, pure-play or stand-alone VOIP providers typically do not offer a service that is comparable in quality to the ILECs' basic exchange services.[70]

In contrast to their consultants, the incumbents in their internal analyses do not appear to consider such pure-play VoIP a serious long-run threat. For example, Verizon's executives appear to *****BEGIN VERIZON HIGHLY CONFIDENTIAL (SUBJECT TO SECOND PROTECTIVE ORDER IN FCC WC DOCKET NO. 05-75)** [71] [72] [73]

[74] **END CONFIDENTIAL*****

This provides another example of how expectations about future competition can fail to manifest. By its own proclamation, AT&T's VoIP service has been a bust and AT&T is barely a whisper on the VoIP competitive front. For example, as part of its justification of its merger with SBC, AT&T has asserted that:

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[69] To the extent that end-users employ VoIP to place local calls using what would have been an incumbent basic exchange service line (or toll calls on a line with a flat-rated toll calling plan), they reduce the incumbent's cost without reducing its revenue.

[70] Cox Opening Comments, 5/31/05, pp. 9-10. In this same section of its Opening Comments, Cox identifies quality limitations of wireless services as well.

[71] Verizon FCC Production, VZCA 00316510, at VZCA 00316546 and 00316554.

[72] *Ibid.*, at VZCA 00316554.

[73] *Ibid.*, at VZCA 00316517.

[74] *Ibid.*, at VZCA 00316541.

> In the wake of the strategic refocus on business services, however, AT&T has substantially reduced investment in the marketing of this VoIP service. AT&T's VoIP service is now marketed predominantly through retail outlets such as Best Buy. AT&T has won only a modest number of customers for this service nationwide…[75]

Based on similar considerations, the FCC has concluded, "Although we recognize that limited intermodal competition exists due to VoIP offerings, we do not believe that it makes sense at this time to view VoIP as a substitute for wireline telephony."[76] The FCC's conclusion applies with special force to substitution for *primary* wireline connections for basic exchange service customers. Indeed, one study cited by Verizon's economic witness in the Verizon-MCI merger proceeding predicts that, even by the year 2009, nearly half of all VoIP subscriptions nationally will be for secondary as opposed to primary line services.[77]

Moreover, there is a considerable amount of room for uncertainty regarding whether VoIP will prove to be a more efficient technology than circuit-switched telephony once the distortions between VoIP and circuit-switched services are eliminated. Certainly, it is currently less expensive to purchase than traditional voice services—provided that the customer already subscribes to high-speed Internet access via DSL or cable modem services. Much of the current price advantage available to VoIP providers for long-distance service, however, appears to be an artifact of unequal regulation. Even SBC-CA witness Dr. Taylor admits that the cost to provide long-distance services via VoIP would go up should providers of those services have to pay the same level of access charges as do interexchange carriers.[78] Should the CPUC wish to consider how "pure-play" VoIP might affect the incumbents' power in the toll market in the long-run, it would first need to study whether "pure-play" VoIP

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[75] A.05-02-027, Polumbo Testimony, 5/6/05, pp. 9-10.

[76] FCC *TRO Remand Order*, ¶ 39, n. 118.

[77] Joseph Lazlo *et al*., "Broadband Telephony: Leveraging Voice over IP to Facilitate Competitive Voice Service", *Jupiter Research*, Vol. 2, 2004, p. 18,cited in A.05-04-020, Rubinfeld Decl., 4/21/05, ¶ 86 and Figure 13, p. 46.

[78] SBC-CA Responses to ORA 5-4 and 5-6.

options will remain viable and how their pricing might be affected after this and other existing disparities[79] are eliminated.

These differences may be resolved, but not without potentially substantial additional investment and/or ongoing cost. One cannot predict with any sort of certainty what these costs may be, or how they would compare with the costs of traditional circuit-switched technology.

D. Other Intermodal Alternatives Have Yet to Achieve Any Significant Commercial Market Penetration

Without evidence that a given source of competition can provide meaningful price-discipline to the incumbents' wireline telecommunications services within the two-year time horizon (following the guidance of the *Merger Guidelines),* the Commission should disregard speculation about possible future competition. Nothing in the incumbents' discussion of "new communications services under development or in the initial stages of deployment"[80] such as 3G mobile wireless, WiFi, Wi-Max, or broadband over power lines suggests that these technologies will provide meaningful price discipline to basic wireline services during the next two years. The fact is that today few residential (or, for that matter, business) customers are served by wireless Internet service providers, which face severe speed, range and reliability limitations, among others.[81] Moreover, the development of next-generation products such as WiMax may be driven by large carriers for business customers, a focus very different from that of Wireless Internet Service Providers (WISPs) that serve residential and small business users. Issues that will need to be resolved before such technologies can be considered a source of competition for residential consumers, such as price, interoperability, and vendor availability, are not yet being addressed and may not be for several years to come. As one analyst recently

[79] For example, VoIP providers are also not required to contribute to federal or state universal service funding mechanisms (although some do make nominal voluntary contributions). Moreover, VoIP providers do not currently provide access to E-911 emergency reporting services equivalent to those being provided by ILECs and CLECs, and do not currently contribute to the cost of maintaining Public Safety Access Points (PSAPs) or other public service programs.

[80] Harris Decl., 5/31/05, pp. 33-34, also at pp. 31-32; Aron Decl., 5/31/05, pp 70-71.

[81] For example, Verizon Wireless's "broadband" service operates at 500kbps, compared to the 1 to 3 mbps speed of most cable modems and DSL.

noted, "In short, WiMAX will not likely be anything like a panacea for WISPs, especially in the short term, and it could easily be as late as mid-2006 before WiMAX systems truly suitable for WISPs become available."[82] The CPUC should disregard all comments concerning these technologies as purely speculative and irrelevant to the current investigation.

E. The Companies That Cried Wolf

To a significant degree, the Respondents' claims regarding the level of competition that they supposedly face and regarding "convergence" in the telecommunications market are a replay of claims that they have been making for nearly a decade. At the time that Bell Atlantic and GTE California filed the merger application to create Verizon, Mr. McCallion was making much the same claims regarding how "today's rapidly changing technology and the significant events that are occurring in the marketplace, such as mergers, new product introductions and regulatory changes" would ensure that competition could flow through merger benefits.[83] As part of his justification for why Bell Atlantic needed to acquire GTE in 1998, Mr. McCallion explained that:

> Indeed, given the fundamental technology and marketing changes occurring such as the growth of the Internet (including Internet protocol telephony), the transition from large centralized switching to decentralized server and router-based technology, and the development of wireless and cable-based alternatives to the local loop (e.g., PCS, digital microwave, cable modems), it would be virtually impossible to isolate the economic benefits associated with the merger for a period beyond four years.[84]

As shown below, the wolves of new technology and intermodal competition that Mr. McCallion saw coming in 1998 still have not appeared (unless one counts the Respondents themselves) and the robust competition he predicted when attempting to justify the GTE/ BellAtlantic merger still does not exist today.

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[82] Steve Stroh, "WISP Heresies," *ISP Plant*, December 24, 2004, available at http://www.isp-planet.com/fixed_wireless/business/2004/stroh_heresies.html, (accessed September 1, 2005).

[83] A.98-12-005, Direct Testimony of Timothy J. McCallion, Chapter VIII, Ratepayer Benefits, 12/2/98, p. 6.

[84] *Ibid.*, p. 8.

Even earlier, in the CPUC's 1995 review of the New Regulatory Framework, Pacific Bell hired Dr. Robert G. Harris, a Director with LECG to prepare a report on "Competition in California Telecommunications Markets."[85] At the time, Dr. Harris argued that "market dynamics will facilitate rapid competitive entry in California" and that "[t]here are several reasons why competition in access and exchange services will develop at a much faster pace than did competition in interLATA services."[86] Dr. Harris went on to assert that there was "evidence of rapid competitive entry into local exchange services" and that "[i]ntervenors overstate Pacific Bell's competitive advantage."[87] He further claimed that "competition in telecommunications services is increasing in California at a rapidly accelerating rate", and "[t]echnological changes [are] reducing entry barriers and enabling 'intermodal' competition across communications networks (e.g., cable telephony, wireless 'loops')."[88] In reaching his conclusions, Dr. Harris relied on the same types of data as do the Respondents today—including such things as analyst speculation and company announcements suggesting that cable and wireless competition was just about to sweep in and wipe away the incumbents' competitive advantage.[89]

Notably, when asked if someone making such claims in 1995 would have been correct, Mr. McCallion responded that such a claim could "possibly" have been correct if one were discussing a very limited set of specific services such as intraLATA toll.[90] This response emphasizes the need to be very specific in identifying which markets are actually experiencing competition. The incumbents' prior claims concerning competition may have been intended to

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[85] I.95-05-047, Dr. Robert G. Harris, Competition in California Telecommunications Markets, Prepared for Pacific Bell, 9/8/95, and Competition in California Telecommunications Markets: Reply, 9/8/95.

[86] Dr. Robert G. Harris, Competition in California Telecommunications Markets, Prepared for Pacific Bell, 9/8/95, p. 2.

[87] *Ibid.*, pp. 3 and 9.

[88] *Ibid.*, p. 1.

[89] *Ibid.*, pp. 23-27, 30 and 37-38.

[90] A.05-04-020, Applicants' Response to TURN Request 3-29.

address only very limited, specific markets, even though they seemed all-encompassing at the time. Similarly, today, the incumbents' claims that their market power has eroded may be true in some specific geographic and product markets, but not at all true in others. The Respondents have not presented the CPUC with sufficient information to make any reasoned evaluation.

Mr. McCallion also admitted that the rapidly changing market and technological conditions the incumbents have cited indeed been ongoing for some time, but claimed they have now reached a (completely undefined) "critical mass."[91] Whatever this amorphous "critical mass" concept may represent, it is decidedly ***not*** an objective standard against which the Commission can test the Respondents' claim that long-standing trends in the marketplace and technology that heretofore have failed to produce a significant loss of incumbent market power are suddenly sufficient to do so now.

The four major California incumbents still dominate the local exchange markets in their respective service territories nearly 10 years after Dr. Harris and Mr. McCallion suggested that the California incumbents were rapidly losing way to cable and wireless competitors. The Respondents likewise have maintained such complete control of the access market that the Commission has a concurrent proceeding to reduce their access changes closer to cost by regulatory action as sufficient competition has never arrived to achieve that result. The Respondents' current speculations about the likely state of future competition may well prove no more reliable than these failed predictions.

The CPUC's decision to grant AT&T non-dominant status in the California interLATA market provides another illustration of how projections based on how competition will develop can "go south." That decision relied (among other things) on an analysis presented by AT&T showing that competitors now controlled nearly 80% of the activated transmission facilities in California.[92] That analysis was based on a study that examined facilities of what were at the

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[91] A.05-04-020, Applicants' Responses to TURN Requests 3-28, 3-29 and 7-11.

[92] D.98-08-060, 8/1/97, Finding of Fact 19.

time AT&T and nine other non-incumbent, facilities-based interLATA providers.[93] Nine of the ten competitors (including AT&T itself) relied on at the time have since gone bankrupt, been acquired by an incumbent or are in the process of being acquired by an incumbent. Thus, if the CPUC were to apply the same standard today, it is quite possible that it would discover that competition for intraLATA toll services has decreased significantly—and will decrease further should the proposed mergers of SBC/AT&T and Verizon/MCI be completed.

This may be an additional reason that SBC-CA and Verizon-CA avoided providing any factual analysis concerning market concentration in California today. Moreover, it is yet another reminder that expert predictions and even the CPUC's expectations regarding how competition will develop in the future do not always materialize. Thus, the CPUC's new framework must include timely monitoring of relevant market developments and provisions for prompt intervention should the competitive forces on which the CPUC relies to constrain the Respondents' market power fail to materialize.

F. MCI's Curious Change of Heart

MCI's support for the notion that the Respondents' wireline services are "now facing competition, not just among themselves and from wireless carriers, but from non-traditional service providers, such as cable companies, VoIP providers, and soon even voice applications offered by other providers such as ISPs and software providers"[94] represents a fairly recent change of heart for the company. As recently as October 2004, MCI was reaching, and stating with some force, very different conclusions regarding the significance and level of intermodal competition.[95] In particular, MCI's comments before the FCC in the *Triennial Review Remand*

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[93] A.94-05-042, Testimony of Del R. Guynes on Behalf of AT&T Communications of California, Inc., 8/7/96, p. 8 and attached report by New Paradigm Resources, Assessing Interexchange Carrier Transmission And Switching In California, July 1996, p. 13 and Appendices 5 and 5.

[94] Opening Comments of MCI, Inc., 5/31/05, p. 2.

[95] MCI Comments In the Matter of Unbundled Access to Network Elements Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers, WC Docket No. 04-313, CC Docket No. 01-338, October 4, 2004 (hereinafter, "MCI FCC *Triennial Review Remand* Comments").

proceeding reached very different conclusions concerning the major forms of intermodal competition discussed in this docket: cable telephony, wireless services, and VoIP.[96]

Ironically, MCI itself very specifically rejected the overall approach of relying on high-level discussions of competition potential at a national or, at best, statewide, level based largely on generic data such as company announcements that it now uses to support its new conclusions.[97] MCI instead insisted that competition in telecommunications markets could only be meaningfully analyzed employing a very granular, specific market-by-market examination.[98]

MCI concluded that the incumbents such as the Respondents retained sufficient market power to thwart competition for residential and small business customers, ***and*** that different competitive concerns, which are nonetheless "every bit as stark," affect the market for wireline enterprise services.[99]

Less than a year ago, MCI argued that the intermodal substitution for the ILECs' services is largely fictional. For example, MCI stated:

> Wireless (including fixed wireless) and cable telephony services (including both traditional circuit-switched cable telephony and emerging packet-switched cable telephony) are relatively new compared to the wireline network, and neither is comparable in cost, quality, or maturity to the incumbent LEC's services. The public has been unwilling to abandon its wireline voice service for these technologies, and quality, reliability, and access to emergency services have not yet been proven to meet the mass market's needs. Only a tiny percentage of persons have given up their local land line service in exchange for wireless or cable telephony service. Even the BOCs do not believe their own rhetoric regarding the competitive significance of intermodal alternatives. SBC CEO Edward Whitacre stated in October 2003 that wireless, as developed as it is, is "not going to displace the wireline network"

[96] *Ibid.*, pp. 82-130.

[97] Opening Comments of MCI, Inc., 5/31/05, Attachment A.

[98] MCI FCC *Triennial Review Remand* Comments, pp. 19-21.

[99] *Ibid.*, *e.g.*, pp. 3-4.

> and is "never going to be the substitute [for wireline]. Reliability is one reason."[100]

MCI also concluded last October that cable telephony was not a mature, significant or widespread alternative to wireline service.

> Furthermore, cable telephony, whether traditional circuit-switched or emerging packet-switched, has not yet been deployed in a manner that allows it to function as a broad replacement for incumbent LEC local exchange service, and is not comparable to the incumbent LEC's local voice service in terms of cost, quality, and maturity. …
>
> It appears that cable companies deploying telephony will be deploying packet-switched systems, rather than circuit-switched to serve residential customers. Packet-switched cable telephony, however, is not yet widely available, despite plans to introduce the service in multiple markets this year. Comcast, for instance, currently offers the service only in certain trial markets, and Cox Communications and Charter offer packetized cable telephony in at most a few markets. Moreover, cable operators have not yet garnered a large number of customers for their packet-switched cable telephony products. According to a recent Communications Daily article, Cablevision has 71,000 subscribers, Time Warner, 20,000-25,000 subscribers, and Charter, 3,000 subscribers.
>
> Cable telephony's lack of maturity is shown by its extremely limited deployment, especially for packet-switched cable telephony. As to cost, some cable operators require consumers to purchase cable telephony as part of a bundle that includes either cable modem or cable TV. Such bundling requirements render the cost of cable telephony significantly higher than the cost of incumbent LEC landline voice service, which can be purchased as a stand-alone product. Additionally, the quality of cable telephony is not equal to the quality of traditional voice service. For instance, packet-switched cable telephony services (like other VoIP services) are subject to significant limitations on 911 dialing and do not have access to backup power in emergencies. Problems with the quality

[100] *Ibid.*, p. 86, quotation citation to "A Wireless World," BusinessWeek Online (Oct. 20, 2003).

> of packet-switched cable telephony and other VoIP services are described more fully in the following section on VoIP.[101]

Although MCI did not dispute that wireless usage can displace some wireline usage[102], it strongly disputed the assertion that any significant portion of customers consider wireless service a substitute for wireline service and cited numerous recent industry surveys, FCC findings, substantial service quality and capacity constraints to support its position.[103] Further, MCI questioned whether wireless could be considered a substitute for wireline service given the incumbents' dominance of the wireless market. MCI stated:

> In addition to the fact that the vast majority of wireless customers are not willing to give up their wireline service, there are questions as to whether incumbent LEC affiliated wireless carriers are even interested in having customers view wireless service as a substitute for wireline service. The two largest wireless providers – Verizon Wireless and Cingular – are owned by three of the four BOCs, and Sprint PCS is an incumbent LEC affiliate. As observers have noted, it is unlikely that the incumbent LECs will permit their sizeable wireless operations to cannibalize their profitable local wireline monopolies. Instead, as confirmed by their statements, the incumbents have a strong financial incentive to perpetuate both the reality and the perception that wireless service is not a substitute for wireline voice service.[104]

In October 2004, MCI vigorously disagreed with many of the Respondents (and now its own) conclusions regarding VoIP. Indeed, MCI asserted that "VoIP services suffer from myriad limitations in ubiquity, cost quality, and maturity that make them no substitute for incumbent ILEC voice services."[105] For example, MCI argued,

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[101] MCI FCC *Triennial Review Remand* Comments, pp. 93-95, footnotes omitted.

[102] *Ibid.*, p. 88.

[103] MCI FCC *Triennial Review Remand* Comments, pp. 88-92.

[104] *Ibid.*, p. 91, footnotes omitted.

[105] MCI FCC *Triennial Review Remand* Comments, p. 99.

> A February 2004 survey showed that only seventeen percent of Americans even have heard of VoIP, and that only three percent of Internet users have considered adopting VoIP technology in the home. Further, as described above, only about 21% of U.S. households subscribe to the broadband service that is a prerequisite to purchasing VoIP service.
>
> The cost of VoIP service also is not necessarily comparable to that of traditional landline voice service. Although the cost of VoIP packages ranges from roughly $20 to $40 per month, those prices do not include the cost of broadband Internet service, which typically costs between $30 and $50 per month. When the latter costs are factored in, VoIP service can be more expensive than local and long-distance packages for traditional calling.
>
> VoIP is subject to a number of quality limitations that do not apply to traditional landline calling. Quality issues include latency (delay) and uneven sound if the broadband connection is being used for another purpose (such as visiting a web site) while simultaneously making a VoIP call. Other problems are that VoIP phone numbers are not available for directory listings and 411 dialing is often not available.[106]

Relative to the supposed wide availability of VoIP, MCI further explained why such claims are entirely irrelevant.

> One hundred percent of Americans have access to Jaguar dealerships, but that does not mean that everyone can afford a Jaguar. The costs associated with high-speed broadband, which are in additional to the cost of obtaining VoIP service, coupled with the need for consumers to have a home computer and at least some technological savvy before being willing to consider VoIP service, mean that VoIP is not a current substitute for POTS.[107]

Looking at essentially the same data as the Respondents have cited in this proceeding, a relatively short time ago, MCI reached opposing conclusions. At a minimum, this suggests

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[106] *Ibid.*, pp. 99-102, footnotes omitted.

[107] MCI Reply Comments In the Matter of Unbundled Access to Network Elements Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers, WC Docket No. 04-313, CC Docket No. 01-338, October 19, 2004, p. 12.

that any conclusions or projections based on those data are highly uncertain. Thus, the Commission should take any claims regarding the level of competition that may emerge in the future based on expectations and projections with several grains of salt. Plainly reasonable people, and even the same party, can reach different conclusions based on expectations about how the minimal competition that exists today will change in the future. As ORA showed above, the Respondents' experts have been overly optimistic regarding when competition might emerge in the future. Given the level of speculation involved in such projections, potential future intermodal competition cannot be a means to ***guarantee*** that the Respondents' prices for basic exchange services will be reasonable today or in the near future.

G. Summary

As noted above, the incumbents relied heavily on anecdotal and circumstantial information, rather than hard data, to make their claims concerning intermodal competition. The above analysis of this information already indicates that it provides little, if any, basis for the Commission to lift price caps for primary residential access lines and basic business access lines.

ORA's conclusion is reinforced by the TNS Telecoms "Bill Harvesting Data" for the fourth quarter 2004 obtained from SBC-CA in discovery.[108] The TNS data include revenue, household and local line market share data for SBC-CA's footprint based on bill packages from 8,000 households that are surveyed quarterly and asked to "return a full set of their telecommunication bills (local, long distance, wireless, cable, satellite and Internet)."[109] Those data include both primary network access line share and also reflect any competitive losses that SBC has experienced for other residential services, including losses due to any intermodal competition.

The TNS Bill Harvesting data show that SBC-CA still controls *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL***** in its footprint, even considering this

[108] SBC-CA Response to ORA 2-6.

[109] A.05-02-027, SBC Response to TURN 1-5.

broadly defined "market" with wireless, cable and satellite competition included.[110] SBC-CA almost certainly has a higher market share for primary access lines than for other residential services. The TNS Bill Harvesting data cast serious doubt on the claims of SBC-CA and the other Respondents that intermodal competitors are significantly eroding their control over the residential market.

V. A REVIEW OF SBC-SPECIFIC EVIDENCE CONCERNING COMPETITION SUGGESTS THAT THERE IS LITTLE JUSTIFICATION FOR ALLOWING UPWARD PRICING FLEXIBILITY FOR CURRENT CATEGORY 2 SERVICES FOR MOST RESIDENTIAL AND SMALL BUSINESS CUSTOMERS.

A. SBC-CA's Line Loss Data Do Not Provide Evidence of Significant Competition for Basic Exchange Services

SBC-CA asserts that, after steady growth from 1984 to 2000, its wireline business subsequently has been declining by 2 percent per year.[111] The Respondents rely on data regarding supposed wireline losses as a cornerstone of their claim that they already face some meaningful level of competition today. Indeed, it appears that as part of its *****BEGIN SBC-CA "LAWYERS ONLY" CONFIDENTIAL** [112] **END CONFIDENTIAL*****

The Respondents' use of such data is selective and misleading. To a considerable degree, the line "loss" numbers that the Respondents use when reporting to regulators are simply an artifact of creative reporting, *i.e.*, of reclassifying lines so that they are no longer tallied as regulated wireline service, even though the underlying facilities are still in use by the same end-user providing basically the same service. Certainly, wireline technology is being supplanted by newer, more robust technology in some applications. The Respondents' own data show, however, that they themselves are the primary suppliers of the replacement services. In other words, to the extent that the reported decline in wireline service volumes actually exists at all, it is principally the result of the incumbents migrating their existing

[110] SBC-CA Response to ORA 2-6, at RROIR 000605-6.

[111] Also, Harris Decl., 5/31/05, pp. 13-14

[112] "Changing the Game with Voice," at pp. 47-48.

customers to newer service options that do not happen to be counted in the “wireline” (or regulated services) bucket.

For example, the incumbents have actively used their unregulated affiliates’ DSL services to cannibalize a significant portion of their prior base of wireline secondary residential lines. In doing so, the Respondents’ parent companies have improved their competitive position by moving a supposedly low-margin, regulated service (residential basic exchange wireline service) onto a non-regulated, presumably more lucrative, advanced service that is known to reduce competitive churn (DSL)—while still making use of their basic underlying, ratepayer-funded wireline plant. Such migrations between incumbent and affiliate products may reduce the Respondents’ reported total or wireline services, but they are not legitimately counted as competitive losses. As ORA demonstrates below, seen in the context of the Respondents’ total business operations, their reported wireline service losses do not translate into any significant competitive loss.

SBC-CA’s ARMIS data indicate that “switched access lines” declined from a peak of 18,799,223 in 2000 to 14,851,608 in 2004, as apparent loss of 3.9 million lines.[113] Switched access lines are, however, only a portion of SBC-CA’s product mix. To a very significant degree, it appears that SBC is merely shifting capacity among its products, while its growth has been unabated. The same SBC-CA ARMIS report also show that its ***total*** access lines (switched and non-switched) ***grew*** from 29.6 million in 2000 to nearly 33.3 million in 2004 in California. SBC-CA does not mention or explain this fundamental contradiction in its own claims about significant line losses, which is only true if one narrowly defines the lines considered to switched, basic exchange service lines.

The apparent loss of 3.9 million primarily consists of three categories of switched access lines: 1.6 million “lost” switched retail business lines, 1.5 million “lost” switched retail primary residential lines, and 537,000 switched retail residential additional lines.

[113] The derivation of these figures and all other data related to SBC-CA line counts in this section are provided in Exhibit 5.

Although SBC-CA's data indicate a 1.6 million line decline in switched business lines, SBC-CA has not necessarily "lost" any business lines at all. Instead, SBC-CA's ARMIS data suggest that much or all of the "lost" business line capacity has merely migrated from switched lines to high-speed, high-volume special access lines. The shift from low-technology switched access lines to non-switched special access lines is more than sufficient to account for the entire reduction in SBC-CA's switched business lines. SBC-CA's ARMIS reports indicate that SBC-CA's non-switched line capacity in service (measured in voice-grade-equivalent lines) actually grew from 10,795,452 in 2000 to 18,389,734—a gain of nearly 7.6 million voice-grade-equivalent lines. SBC-CA's growth in non-switched lines (the vast majority of which would be business services) swamps its supposed loss of switched business lines, resulting in a combined net gain of nearly 6 million voice-grade-equivalent lines.

SBC-CA claims that its basic exchange business service is priced below cost.[114] There is no indication, however, that SBC-CA believes its non-switched services are priced below cost. Thus, if SBC-CA believes its own rhetoric, moving customers from allegedly below-cost basic exchange switched service to a more profitable non-switched alternative can only improve its total company profitably. Hence, it is misleading to consider the migration of switched business lines to non-switched lines a loss at all. It is better described as an artifice of selective reporting.

Moreover, SBC-CA's reported "loss" is limited to *retail* wireline service. Therefore, it does not reflect business lines that are currently provided over SBC-CA's own wireline facilities as UNE-P services, for which SBC-CA is compensated.[115] Given that the UNE-P service option is being phased-out, it is highly likely that many of these lines will soon return to SBC-CA retail service. Should one also count 90% of the current UNE-P loops as not "lost," SBC-CA's business line equivalent gain is well over 6 million lines.

SBC-CA reports over 1.5 million "lost" primary residential lines. As with business lines, this is a reported loss of ***switched retail*** lines. This reported "loss" ignores that SBC-

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[114] SBC-CA Response to ORA 5-14.

[115] SBC-CA Response to ORA 11-1.

CA's primary competition in the residential market has heretofore been provided by UNE-P based competitors using SBC-CA's own wireline facilities. Given that UNE-P is being phased out and that SBC-CA's major UNE-P competitors are acquired and claim to be exiting the consumer market business, it is reasonable to assume that the vast majority of these lines will soon return to SBC-CA retail service. As of March 2005, SBC-CA reports that it was providing *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL***** Thus, the bulk of this reported line loss is also merely a result of selective reporting.

SBC-CA also claims that one of the significant sources of wireline loss is to wireless service customers that "cut the cord."[116] Should the Commission credit that claim as significant, it should also take into account the percent of SBC-CA primary residential wireline customers shifted to SBC-owned wireless facilities. SBC-CA claims that its basic exchange residential service is priced below its cost[117], implying that the service generates a loss for SBC-CA. If, in contrast, the average Cingular wireless service is priced above cost, that service would generate a profit for SBC. Under these circumstances, SBC can increase its total corporate profit by encouraging customers to switch from its (supposedly money-losing) SBC-CA wireline service to its (presumably profitable) Cingular wireless service. There is thus some logic to the fact (which SBC-CA admits), that it uses its SBC-CA employees and third-party vendors to market its "competitive" wireless services.[118] Indeed, *****BEGIN SBC-CA "LAWYERS ONLY" CONFIDENTIAL** [119] **END CONFIDENTIAL***** Again, it is inappropriate to consider such migrations from one SBC-CA service to another affiliate's service a "loss."

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[116] *E.g.*, Harris Decl., 5/31/05, pp. 22-23.

[117] SBC-CA Response to ORA 5-14.

[118] SBC-CA Responses to ORA 9-1 and 9-2.

[119] "Changing the Game with Voice," p. 48.

SBC-CA estimates that its Cingular affiliate has *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL***** subscriber lines in California.[120] If even 5 percent of those customers replaced SBC-CA primary residential wireline service with wireless service, SBC-CA's total potential universe "lost" primary residential wireline services drops to just over *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL***** percent of its total primary residential lines in 2000. Of course, in addition to these few wireless lines that may have replaced (supposedly money-losing) basic residential service lines, SBC also enjoys millions of additional wireless service connections and a major share of that growing market.

Even this figure is likely to be exaggerated. For example, SBC-CA admits that residential customers in large, multiple dwelling unit location can be provided service using SBC-CA facilities that are not counted as residential switched access lines in its ARMIS reports.[121] Thus, for example, it is possible that some of what appears as the business line growth discussed above is actually residential service provided as part of the service to a large building.

Relative to SBC-CA's reported 537,000 line decline in secondary residential lines, it is common knowledge that the large growth in secondary lines at the turn of the century was largely fueled by lines purchased mainly dial-up Internet access and for data (fax) transmissions. Since that time, broadband service has become the state of the art means to reach those same ends. As noted above, moving customers off of switched second lines would appear to be in SBC's own best interest for a number of reasons, including potentially increased earnings, the transfer of earning from regulated to non-regulated operations and decreased customer churn. Hence, it again comes as no surprise that SBC-CA actively markets DSL service despite the fact that it will often replace a secondary residential wireline service—while still using an SBC-CA, ratepayer-funded wireline facility.[122] Again, these lost secondary residential lines cannot be legitimately considered a loss. Netting SBC's 2.1 million California

[120] SBC-CA Response to ORA 2-3.v.

[121] SBC-CA Response to ORA 10-2.

[122] SBC-CA Responses to ORA 9-3 and 9-4.

DSL lines (as of May 2005) against its "lost" secondary lines thus produced a net gain of over 1.6 million lines for SBC as a whole.

Admittedly, the comparisons provided above do not line-up perfectly. As examples, SBC (Cingular) wireless service is equally or more likely to substitute for a secondary residential line as for a primary line, and some portion of the SBC-provided DSL lines are likely serving as substitutes for additional business lines as opposed to residential lines. Such concerns, though, are "ironed out" in viewing the pieces together (*i.e.*, the net change in business line in-service capacity, the net change in primary residential lines considering SBC's own wireless facilities and its continued ownership of UNE-P facilities—not to mention UNE-L—and its own substitution of DSL for secondary residential lines). Doing so suggests that SBC has gained more than 7.6 million lines in California when one factors in the (typically advantageous to SBC) migration that has occurred in the manner in which services are delivered.

Although this discussion of SBC-CA line losses is not intended as an analysis of any particular product market, the analysis nonetheless is consistent with how SBC talks to investors about how well its business is doing—which provides a sharp contrast with the presentation it makes for regulators. For example, SBC's 2004 annual report presents totals for all of its customer connections in one concise table. Thereby, SBC shows investors that, as a whole (considering its wireline access lines, DSL lines and wireless customers), the company has increased its customer connections from 80,580,000 in 2000 to 106,469,000 in 2004 (over 32%). These figures provide additional support for the view that SBC's subsidiaries ASI (its broadband provider) and Cingular (its jointly owned wireless provider) are in large part responsible for wireline losses from its ILEC. At the same time, SBC's long-distance lines have rocketed from 3,043,000 to 20,868,000—a meteoric rise that its proposed merger with AT&T would only further accelerate.

Likewise, when SBC plans its ILEC business internally, although it may not consider wireless earnings, it generally *****BEGIN SBC-CA CONFIDENTIAL** [123]. [124] [125] [126] [127] **END**

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[123] SBC-CA Response to ORA 10-7, at RROIR 015030.

CONFIDENTIAL*** In short, despite SBC-CA's supposedly substantial wireline losses, there is no sign that SBC-CA has actually lost any significant ground to competition and no evidence that it is likely to lose its dominant position in the near future.

B. SBC-CA Has a Dominant Market Share for Residential and Single-Line Business Services, Especially in Rural Areas

The most current quantitative data available to parties in this proceeding relative to competition in SBC-CA's local service area suggests that the company continues to be the strongly dominant provider of both residential and single-line business basic exchange services. SBC-CA either has not yet faced significant competition or has, for the most part, successfully fended off that competition. Indeed, the most recent data SBC-CA provided show that competitive entry *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL***** SBC's acquisition of AT&T would accelerate that trend.

Using SBC-CA's data concerning all the facilities it provides to competitors (resale, UNE-P and UNE-L) and 911 records of all basic exchange service facilities provided competitors, ORA has compiled SBC-CA's market share for both residential and business basic exchange services and has calculated the Hirschman-Herfindahl Index (HHI) for both of those "markets" as a whole.[128] Thus, ORA's analysis includes intermodal competitors to the extent that those competitors provide their customers with E911 listings.[129]

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[124] *Ibid.*, at RROIR 015106, 015108-10, RROIR 015103C-E, 015103H.

[125] *Ibid.*, at RROIR 015112A.

[126] *Ibid.*, at RROIR 015107, 015102, 015103A-B.

[127] *Ibid.*, at RROIR 015103F-G.

[128] Insofar as possible given the limitations of the available data, this analysis applies economic principles and techniques outlined in the *Horizontal Merger Guidelines* published by the Department of Justice and Federal Trade Commission. ORA's opening comments explained the manner in which ORA recommends use of the *Merger Guidelines* approach to analyze the competitiveness of California's intrastate telecommunications market. ORA's May 31st Comments, Section VI.A.

The spreadsheets used to calculate SBC-CA's overall business and residential market share and HHI results discussed in this section are provided in Exhibit 6. Because the purpose of this analysis is to assess SBC-CA's share of the market for basic exchange service, ORA has excluded competitive loops utilized by Covad and New Edge, which are providers of broadband/data services instead of basic exchange service. Should the

ORA notes that market definitions reflecting the economic principles of the *Merger Guidelines* would be more granular than this analysis of all residential and all business basic exchange service lines throughout the SBC-CA service territory. As one example, ORA believes it is appropriate to conduct separate analyses of market concentration for secondary residential lines as distinct from primary lines. Both the line loss data discussed above and the differential significance of intermodal competition for these two types of lines would justify such a distinction. Unfortunately, the CPUC does not collect and the Respondents claim not to have data that would allow more detailed market share and concentration analyses (although ORA discusses below internal SBC survey data that provide some insight into competition for residential primary line services). The results of the analysis presented here, which uses the most current quantitative information available to parties in this proceeding relative to competition in SBC-CA's local service area, are nonetheless instructive and suggest that SBC-CA's dominance of basic services has not significantly eroded.

SBC-CA's data indicate that its share of all basic exchange residential service is about *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL*****, and that the HHI for this "market" is 7,068, which is several times the 1,800 threshold that the Department of Justice and Federal Trade Commission use to define a "highly concentrated" market. SBC-CA's data also indicate that its share of all business basic exchange services is *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL*****, and that the HHI for this

Commission wish to evaluate how our market share and HHI results would change if these companies are included in the analysis, the first "tab" of Exhibit 6 includes a "trigger" that automatically includes results for these companies. Exhibit 6 also provides "triggers" that automate other sensitivity analysis such as combining SBC-CA and AT&T retail loops and eliminating services that are provided entirely over SBC-CA's facilities (resale and UNE-P).

[129] Cable telephony providers typically offer their customers E911 listings and, as expected, the data ORA used appear to include lines provided by cable-based competitors. The competitors most likely to be omitted from this analysis are "pure-play" or stand-alone VoIP providers and wireless carriers. The very fact that these competitors do not offer E911 listings suggests that they are not providing services that are truly comparable to Verizon-CA's basic exchange services and should not be included in the same market. Further, as is explained in the discussion of intermodal competition in Section IV above, ORA believes that are numerous other reasons to discount the competitive significance of wireless and "pure-play" VoIP providers, especially for residential primary line and business single line services.

"market" is 5,150.[130] Again, this result (although lower than that for residential basic exchange services) indicates a very "highly concentrated" market.

SBC-CA's leading residential basic exchange competitors are: *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL***** No other entrant has as much as a 1% share of residential basic exchange services. As noted above, Cox appears to focus on a high-end niche of customers in its franchise area and has been marketing its phone service for some time. Hence, there is no reason to expect that its market share will grow significantly in the near future.

SBC-CA's leading business basic exchange service customers are: *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL***** No other entrant has as much as a 1% share of business basic exchange services.

Should SBC consummate its merger with AT&T (currently, a leading competitor for both residential and business basic exchange services), SBC's share of residential basic exchange service would increase to *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL*****, *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL***,** yielding an HHI of 6,316.

Given recent regulatory decisions, the longevity of any UNE-P based competition is dubious, at best. Likewise, given the limited wholesale discounts available, competition via resale does not appear to be a significant or growing mode of entry. If companies as large as, and with the depth of telecommunications experience of, AT&T and MCI cannot make a go of either UNE-P or resale-based competition, it is unreasonable to expect that other companies will somehow be better positioned to do so. If one assumes that these forms of competition (pure resale and UNE-P) that rely entirely on SBC-CA facilities and regulatory controls (some of which are already gone) will not endure, a "forward-looking" analysis would consider only SBC-CA's competition that is facilities-based.

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[130] The results ORA obtains here are almost identical to those obtained by TURN's economic consultant, Dr. Trevor Roycroft, in analyses presented in his declaration supporting TURN's opening comments. *See, for example,* Declaration of Trevor R. Roycroft, Ph.D, on Behalf of The Utility Reform Network, May 31, 2005, p. 6, Chart 1. The slight differences between Dr. Roycroft's calculations and those of ORA are immaterial to the interpretation of the results.

ORA used SBC-CA's E911 data to produce what is in effect an analysis of "wholesale" facilities-based competition in which retail service provided using SBC-CA facilities is counted in SBC-CA's market share. Based on this analysis, SBC-CA has a *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL***** share of residential basic exchange service, with an HHI of 8,618, and a business basic exchange services share of *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL***** with an HHI of 6,513. Notably, SBC-CA's underlying E911 data also suggest that SBC-CA is not losing significant numbers of residential customers to facilities-based competition. The total change in residential E911 listings for facilities-based providers from year-end 2003 through March 2005 was *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL*****

Further, should Verizon's proposed merger with MCI complete, it is reasonable to expect that Verizon will not maintain MCI's presence in the SBC-CA footprint, at least for residential and smaller business customers, as there is no sign that Verizon even attempts to compete outside of its footprint in California. For example, Verizon's share of the residential market in the SBC-CA footprint is only *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL*****

There is no reason to suspect that Verizon will change its practice as a result of a merger with MCI (unless it is ordered to do so as a merger condition). Should most or all of MCI's current share of the residential market (and much of its business share) return to SBC-CA, which is likely, it would boost SBC-CA's share of residential basic exchange lines to *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL*****, even assuming other resale and UNE-P competition remained. The increased market share due to the withdrawal of MCI from the residential market is obtained by simply adding MCI's *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL*****

C. SBC's Internal Data Confirm the Reasonableness of ORA's Independent Analysis of Market Concentration

ORA's analysis is highly consistent with SBC-CA's own internal market share analysis. In response to discovery, SBC-CA provided market share survey results for the residential/consumer and small business markets prepared by its Customer Analytics and

Research organization for the fourth quarter 2004, for February 2005, and partial results for May 2005.[131] According to SBC's documentation of its survey methodology, the surveys are based on *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL*****

The surveys present results SBC-wide, by state and for selected metropolitan areas within states.[132] For California, in addition to statewide results, the surveys include specific analysis of the Los Angeles, San Francisco, San Diego, and Sacramento. Further, in addition to providing results for "primary LOCAL telephone service," the surveys also provides other information of interest such as the percent of customers with wireless service, wireless market share, long distance market share and Internet service provider market share. Curiously, the surveys provide two sets of statewide results. The latter results, which are "intermingled" with the metropolitan area-specific results are, according to SBC's note, "out side estimate of SBC share" [*sic*.][133] This appears to provide the market share for all SBC-CA portions of the state outside of the major metropolitan areas that are individually tracked.[134]

SBC's residential and small business market results for all competitors with more than a 1 percent statewide share are provided in Tables 3 and 4 below.

[131] SBC-CA Response to ORA 2-5. In addition, SBC-CA supplied what appear to be selected results from what may be the same report from May 2005. SBC-CA Response to ORA 4-12.

[132] *See* SBC-CA Response to ORA 2-5, Consumer and Small business surveys.

[133] *Ibid.*

[134] SBC-CA provided its complete 4th Quarter 2004 and February 2005 reports in Excel format, including data for other states and services. For ease of reference, ORA provides PDF extracts from these surveys as part of Exhibit 1 in which all non-California results have been removed and that are sorted by market share based on the first column of California-wide data. However, for completeness, ORA also provide full versions of the Excel files with the surveys. SBC-CA provided only a partial, paper-only version of the May 2005 survey. Hence, the May study is provided in that format only in Exhibit 1

Table 3

SBC CONSUMER MARKET SHARE SURVEY RESULTS

Competitor	4Q 2004 Share	Feb. 2005 Share	May 2005
*****BEGIN SBC-CA CONFIDENTIAL**			

END CONFIDENTIAL***

Table 4

SBC SMALL BUSINESS MARKET SHARE SURVEY RESULTS

Competitor	4Q 2004 Share	Feb. 2005 Share	May 2005
*****BEGIN SBC-CA CONFIDENTIAL**			

END CONFIDENTIAL***

SBC's survey not only shows that it dominates the provision of residential and small business services, with "market" shares reaching nearly (or more than) *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL*****should the merger with AT&T complete. It also shows that SBC's market share *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL*****

The trend (or lack thereof) reflected in SBC's market share studies is consistent with other internal SBC analysis. As discussed above, SBC's 2005 business plan and 2004 review indicates that SBC-CA's line losses *****BEGIN SBC-CA CONFIDENTIAL** [135] [136] [137] [138] [139] **END CONFIDENTIAL***** Hence, the only available empirical data indicate that SBC-CA is beating back what competition does exist ***under the existing regulatory framework***.

SBC-CA is undoubtedly taking advantage of its increased control of the market to move customers to bundles, which will make it increasingly difficult for competitors entering in the future to capture market share. For example, SBC's data shows that *****BEGIN SBC-CA CONFIDENTIAL** [140] **END CONFIDENTIAL*****

The more competition is about bundles, the less consumers may be willing or able to switch carriers in response to price changes. Compare the ease and low cost of changing one's presubscribed stand-alone long-distance carrier (a so-called "PIC" [primary interexchange carrier] change) to the nuisance and high cost of changing providers for a service now purchased as part of a bundle. A residential bundled service customer who wants to change her phone service must decide whether it is worth paying more to buy stand-alone services from an assortment of providers or putting up with the cost and inconvenience of changing her

[135] SBC-CA Response to ORA 10-7, at RROIR 015107, 015102 and 015103A.

[136] SBC-CA Response to ORA 10-3, at RROIR 014019.

[137] *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL*****

[138] *Ibid.*, p. 000149.

[139] *Ibid.*, pp. 000149 and 000150.

[140] SBC-CA Response to ORA 6-8, at RROIR 013990.

ISP, her video provider (potentially with different channels and a new box installation appointment), paying more for her wireless service or changing to a new provider (and possibly needing to buy a different cell phone, necessitating re-entry of personal address books, speed call numbers and the like), etc. This customer is likely to stick with her existing bundled service provider unless the service quality becomes extremely bad or the price difference between her current provider and a competitor is quite large.

Providers of telecommunications services well understand the "sticky bundle" principle. For example, SBC has announced that:

- Adding long distance to an access line reduces the company's churn rate by 9 percent.
- Churn drops by 61 percent when a DSL line is added to an SBC bundle.
- Together, long distance and DSL reduce churn by 73 percent.[141]

Thus, as one would expect, an SBC May 2005 analysis shows that *****BEGIN SBC-CA CONFIDENTIAL** [142] **END CONFIDENTIAL*****

SBC's survey data also appears to undermine any claim that a significant number of customers are replacing their primary household wireline service with wireless service. In the consumer survey, *****BEGIN SBC-CA CONFIDENTIAL** [143] **END CONFIDENTIAL*****

Also of note in SBC's survey is the level of SBC's dominance in other areas. The May 2005 consumer data shows that SBC already controls a *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL.**

SBC did not provide the wireless portion of its survey for May 2005. However, SBC's survey from February 2005 suggests that *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL*****

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[141] SBC Press Release, "SBC Communications Provides Progress Report on Major Growth Strategies, Outlines Broad Service and Cost Initiatives," Nov. 13, 2003.

[142] SBC-CA Response to ORA 10-3, at RROIR 014020.

[143] It is possible that some fraction of wireless service is mixed in with other provider shares such as the generic "AT&T" and "SBC" designations, but it is impossible to know for sure based on what is available in the survey. However, based on the shares for other wireless carriers, any wireless presence in those data are not likely to be significant.

What may be somewhat surprising is that the survey also shows that SBC/AT&T also dominate *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL*****

Thus, it appears that, rather than shrinking under a flood of competition, SBC has been leveraging its dominance of the local exchange market to become dominant in related consumer markets.

This extreme market concentration places small businesses in a particularly precarious position relative to any relaxation in the regulation of increases to basic services. For example, SBC-CA already has been actively attempting to raise basic local service rates for businesses since at least 2000, when it filed an application seeking permission to do so.[144] Although the SBC-CA application would, in theory, have raised basic service rates for businesses of any size, the burden of an increase would, as a practical matter, fall heavily on small businesses. That would occur because, where any alternative provider might exist, they would very likely target larger businesses (and, thus, larger revenue opportunities) and because, should SBC-CA actually feel compelled to respond to competitive pressure, it would be much more likely to establish bulk or other contract rate discounts for larger businesses than for small businesses. Small businesses would, therefore, most likely have no alternative but to absorb rate increases.

Moreover, as discussed above, no matter how broadly one stretches the notion of the relevant market to consider forms of intermodal competition that SBC-CA relies on to assert that competition exists, a review of the available factual data still reveals that the markets for basic service are highly concentrated. The current picture is one SBC-CA as a heavily dominant ILEC, heretofore challenged primarily by AT&T, which it may be about to acquire To meet its mandate to protect ratepayers, the Commission should give this existing, factual data far greater weight than expert projections and speculation about supposedly robust future competition. This is doubly true as such predictions have routinely proven false in the past.

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[144] *See* A.00-09-061.

D. Competition Is Not Uniformly Distributed Geographically in the SBC-CA Service Territory

SBC-CA's data point to a second important fact about competition in California, which is that it is far from uniform.[145] For example, the SBC May 2005 market survey discussed in the prior section indicates that SBC-CA's overall share of the California local service market is *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL*****

The difference in underlying competitors is also revealing. In Los Angeles, San Diego and San Francisco, Cox and/or Comcast *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL*****

The same basic pattern also appears in the small business survey results except that *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL***** If the CPUC were to rely on intermodal competition (as opposed to regulation) to put pressure on SBC-CA's basic service rates, residential and small business customers in some portions of the state would have much longer to wait than customers in other locations for that pressure to manifest. .

ORA's analysis of SBC-CA data concerning lines provided to competitors (see Exhibit 6) confirms that competition varies significantly at the wire center level.[146] Relative to residential basic exchange service, *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL***** Even at the low end of this distribution, the HHI results indicate highly concentrated markets.

Relative to business basic exchange service, *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL***** Again, even at the low end of this range, the HHI results for business basic exchange service indicate highly concentrated markets.

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[145] CSBRT/CSBA cite geographic differences in competitive activity as a rationale for continuing price caps for basic exchange services for residential and small business customers. Opening Comments of California Small Business Roundtable and California Small Business Association, May 31, 2005 (hereinafter, "CSBRT/CSBA Opening Comments"), p. 7.

[146] Unfortunately, ORA's wire center analysis is not a precise as its overall analysis because SBC-CA was not able to associate E911 records with specific wire centers. Hence, ORA's wire center level HHI calculations are based entirely on UNE and resale competition.

The wire-center results exhibit a significant range, which confirms that competition is not developing evenly throughout SBC-CA's service area. Such variations are likely to be particularly strong in underserved markets or market segments with no (or few) effective competitive options (*e.g.*, rural and other neighborhoods without cable telephony, the small business market, low-income and minority neighborhoods). In those markets, SBC-CA will have every incentive to cut back on maintenance of basic services and divert resources to, for example, building out broadband in affluent areas.

This reality was underscored in a 2004 SBC presentation to investors wherein SBC unveiled its "Project Lightspeed" initiative to extend fiber-optic technology closer to customers' premises, thereby reducing SBC's cost to operate and maintain its network and increasing its ability to offer high-speed data services, as well as video services.[147] Notably, SBC's materials disclose how the company segments its customers into three groups based on average revenue per customer: "high-value customers" (who spend between $160 and $200 per month on services from SBC and other providers, including video providers); "medium-value customers" ($110-$160 per month) and "low-value customers" (under $110 per month).[148] "Low-value customers" (presumably those who purchase basic local exchange service and at most a minimal amount of vertical features or long-distance services plus, perhaps, basic cable services) make up fully 35% of SBC's customer base. Yet, SBC's network modernization initiative will "cover" only about 5% of these low-value customers, as opposed to 90% of high-value customers and 70% of medium-value customers.[149]

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[147] The presentation was made in conjunction with a Web cast that SBC presented on November 11, 2004. The Web cast and slideshow are available at http://phx.corporate-ir.net/phoenix.zhtml?c=113088&p=IROL-eventDetails&EventId=966334 (hereinafter "Lightspeed Presentation").

[148] These breakpoints are reported in media articles describing the SBC Web cast, including Ed Gubbins, "SBC clarifies FTTN, FTTP plans," *Forbes.com*, 11/12/04, available at http://www.forbes.com/technology/feeds/general/2004/11/12/generalprimemedia_2004_11_12_eng-primemedia_eng-primemedia_113020_8569469585142666429.html?partner=yahoo&referrer=

[149] Lightspeed Presentation, p. 14.

E. SBC-CA's Residential Inside Wire Maintenance Plan Illustrates the Dangers of Upward Pricing Flexibility without Sufficient Competition

The pricing history of SBC-CA's residential inside wire maintenance plan illustrates the dangers of premature deregulation. The CPUC reclassified SBC-CA's residential inside wire maintenance plan from Category 2 to 3 in June 1999[150] (and authorized an initial rate increase for the newly recategorized service). It took less than two years for SBC-CA to increase the rate for that service from $0.60 (the level authorized at the time of recategorization) up to $2.99 per month—a 400% rate increase.[151] SBC-CA might well have continued to push the price higher had the CPUC not imposed a provisional cap on the rate for this supposedly fully competitive service at the $2.99 level.[152]

SBC-CA's rapid and massive rate increases for one of its most popular optional services[153] might lead one to presume that its price for this service prior to recategorization was significantly below cost. Indeed, SBC-CA made that claim, and the Commission accepted it.[154] *****BEGIN SBC-CA CONFIDENTIAL** [155] [156] **END CONFIDENTIAL*****

In the alternative, one might presume that SBC-CA let "the market establish" its new inside-wire maintenance plan pricing—*i.e.*, that the increased price reflected "competitors' pricing and marketing strategies," as SBC-CA claims is its practice for competitive products.[157]

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[150] D.99-06-053.

[151] D.02-12-062, pp. 2-3 and 5.

[152] The Commission imposed this rate cap in response to a Petition from ORA and TURN. D.02-12-062, pp. 1 and 3.

[153] SBC-CA Response to ORA 8-1 and Calculations in Exhibit 1, which shows that in July 2003 SBC-CA had *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL*****

[154] D.99-06-053.

[155] SBC-CA Response to ORA 8-5 and Calculations in Exhibit 1.

[156] D.02-12-062 states that "ORA previously acknowledged that Pacific's then existing $.60 RIWR WirePro service rate had been priced below cost." (D.02-12-062, p. 10.) In light of *****BEGIN SBC CONFIDENTIAL END CONFIDENTIAL*****

[157] SBC-CA Response to ORA 5-17.

This presumption, however, cannot be correct as there is no market for ***monthly maintenance plans***. Local tradespersons may have the skills and wherewithal to compete with SBC-CA in the provision of inside wire repair per visit when problems occur. Such competitors do not have pre-existing billing relationships with the broad base of SBC-CA residential customers that permit them, at virtually no incremental cost, to bill and collect a monthly insurance premium in exchange for a guarantee of future service.[158]

The current $2.99 price for its residential inside-wire maintenance plan allows SBC-CA to generate an extraordinary *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL***** Despite the significant amount of money "on the table," there is no sign that any competitors have begun to offer alternative inside-wire maintenance plan products as one would expect in a truly competitive market. Instead, SBC-CA has managed to exploit its unique position as a provider of what has effectively remained a monopoly product to "back-door" a monthly rate increase of over $2 for a significant portion of California residential customers.

This example provides a strong illustration of SBC-CA's willingness to extract monopoly profits when and where it can. The CPUC can expect that SBC-CA (and the other Respondents) will exploit any similar opportunities that arise if the CPUC grants additional upward pricing flexibility as part of a "Uniform Regulatory Framework" without a compelling showing that the incumbents do not retain significant market power in well-defined markets.

F. SBC-CA Also Has Raised Prices for Business Services Subject to Upward Pricing Flexibility

1. Business Inside Wire Maintenance Plans

As noted above, SBC-CA's residential WirePro rate has increased five-fold (or 400%) since the recategorization authorized in D.99-06-053.[159] Similarly, SBC-CA has raised its

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[158] Even if one presumes that there are competitors that could come close to matching SBC-CA's own reported *****BEGIN SBC-CA CONFIDENTIAL END CONFIDENTIAL*****

[159] See AL 21585, effective June 2000, and AL 21593, effective March 1, 2001. See Attachment containing supporting documentation for the price increases cited in ORA's Phase 3A Opening Comments. In D.02-12-062 (December 19, 2002), the Commission provisionally capped SBC-CA's residential Wirepro rate at $2.99, in response to ORA's Petition for Modification of D.99-06-053.

Business inside wire maintenance plan from $1.30 to $4.65 per month, an increase in price of 358% since D.99-06-053 re-categorized the service from Category II to Category III, i.e. "fully competitive" services.[160]

2. Business Message Telecommunications (MTS, or Business Toll) Service

SBC-CA's Business Message Telecommunications (MTS, or Business Toll) Service was recategorized to Category III by D.00-05-020 (May, 2000). The recategorization of Business Toll was followed by sizeable rate increases. Since then, SBC-CA has more than ***doubled*** its business MTS rates, raising them to a level that represents an overall average price increase of approximately 152% over the MTS rates in effect prior to recategorization.[161] Similarly, SBC-CA raised its Custom 8 toll service by approximately 97% since recategorization.[162] Such rate increases must be considered dramatic and substantial for services that SBC-CA has alleged to be "fully competitive."

3. Centrex Services

SBC-CA's Centrex services were recategorized to Category III in May 2000 by D.00-05-020. Pacific then raised its Basic Centrex tariff rate from $8.35 to $9.56 (an increase of 14%)[163], and its Centrex basic feature tariff rate from $2.04 per month, to $6.99 (an increase of 243%)[164].

The rate increases described above have more than offset the beneficial effects of the Commission's universal service rate rebalancing proceeding for business customers purchasing MTS, who have experienced more than a **doubling** (152% increase) in their toll rates. SBC-CA's post-recategorization price increases have dramatically increased the costs to inside wire

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[160] Implemented by Advice Letter 25843, filed 11/29/04.

[161] This percentage reflects price increases noticed in Advice Letter 27286, filed August 30, 2005. ORA's calculation uses call distribution data provided by SBC-CA.

[162] Advice Letter 26889, filed 6/13/05.

[163] Advice Letter 21668, effective May 1, 2001.

[164] Advice Letter 26888, filed 6/13/2005.

customers as well. Residential inside wire plan subscribers have experienced a 400% increase in their monthly rate, while business customers have had to bear a 358% increase. The large price increases for SBC-CA's recategorized services suggest that the services in question are not being priced in a competitive market or that the market in its present state provides few pricing restraints. Services that were once part of a incumbent monopoly provider's bundled service offerings cannot be considered "fully competitive" as long as the incumbent continues to dominate the provision of basic local exchange telecommunications services. Moreover, even for services for which competitive alternatives exist, SBC-CA appears to maintain significant market power. Customers' habitual reliance on SBC-CA for their telecommunications services has helped SBC-CA maintain a stronghold on the markets in which it serves.

Thus, where SBC-CA has been allowed full pricing flexibility, it has taken full and apparently unreserved advantage of that authority to substantially raise rates.

G. Summary

SBC-CA's proposal to remove price caps from basic services is plainly not about obtaining freedoms that it needs to compete successfully. If that were the case, SBC-CA would be asking only to be able to ***reduce*** prices to meet competition (as ORA recommends). Moreover, SBC-CA already has the capability to offer a wide range of promotions and can use its authority to offer customer-specific contracts to offer specific discounts as needed to meet or beat competitive offers. SBC-CA can and does already offer service bundles.[165] Further, should SBC-CA have evidence that a competitive market exists for any product or group of products that it offers the existing regulatory framework allows it to apply for essentially unlimited flexibility. Thus, SBC-CA's proposal for upward pricing flexibility is entirely unnecessary as a response to competition.

Instead, as the evidence presented above makes clear, SBC-CA's proposal is–purely and simply—a means to enable SBC-CA to raise basic service rates without providing needing any justification or demonstrating that they face any meaningfully price constraining competition

[165] SBC-CA Response to TURN 1-43.

or even any audit trail showing how such changes affect SBC-CA's earning. With such freedom, SBC-CA would be free to squeeze captive or unwary customers either to fund discounts for service bundles that may be starting to face competition or to export increased earnings from California ratepayers to its headquarters and shareholders.

SBC-CA barely hesitates in conveying its intention to raise basic service prices. Indeed, SBC-CA goes so far as to imply that it would be doing California customers and the CPUC a favor by raising those prices to cover at least the current price floors because, allegedly, its current low prices are creating a barrier to competition.[166] Given the existing price floors, SBC-CA's "pro-competitive" rate increases would be tremendous. Table 5 compares the existing price floors for SBC-CA's residential measured-rate service (1 MR), residential flat-rate service (1 FR) and business measured-rate service (1 MB) to SBC-CA's current prices (excluding the effects of surcharges or surcredits). As Table 5 reveals, any action by SBC-CA to raise the prices for these services to at least the level of the current price floors would result in substantial rate increases for California consumers.

Table 5

POTENTIAL SBC-CA PRICE INCREASES

	Current Price Floor[167] (SBC-CA CONFIDENTIAL)	**Current Price (Excluding Surcharges/Surcredits)**	**Amount by which Price Floor Exceeds Current Price (SBC-CA CONFIDENTIAL)**	**Percentage Increase Required to Bring Current Price up to Price Floor (SBC-CA CONFIDENTIAL)**
Residential Measured-Rate Service	*** ***	$5.70	*** ***	
Residential Flat-Rate Service	*** ***	$10.69	*** ***	
Business Measured-Rate Service	*** ***	$9.80	*** ***	

[166] Borsodi Decl., 5/31/05, p. 22.

[167] SBC-CA Response to ORA 2-16.

Not only has SBC-CA implemented such increases whenever allowed to do so in the past, it is *****BEGIN SBC-CA CONFIDENTIAL** [168] **END CONFIDENTIAL***** Absent price caps, the sky is likely the limit.

Although SBC-CA claims that it sets prices for competitive services based on considerations of market rates, SBC-CA admits it has no existing methodology for actually conducting any such review. Nor could SBC-CA can find any record that it actually bothered to investigate what the existing "market rates" might be before proposing to increase prices for services that the CPUC previously has found to be competitive.[169] One plausible explanation for this lack of "market rate" studies is that SBC-CA recognizes it faces little actual competition for the supposedly competitive services (including inside wire maintenance plans, custom calling features and basic toll service) for which it has raised prices. SBC-CA's awareness of the lack of competition also could explain why its proposed rate changes over the past few years have been almost entirely rate increases.[170]

Now, SBC-CA asks the Commission to change the rules so that it can raise rates at will. Only the most charitably inclined can imagine that SBC-CA's motive for doing so is to make California markets more attractive to competitors, as SBC-CA suggests. The CPUC instead should presume that SBC-CA will engage in what economists call "limit pricing"—in other words, that SBC-CA will exercise upward pricing flexibility as far as it can ***without*** incurring significant competitive losses. The company has proven adept at this strategy with respect to services for which the CPUC previously has granted upward pricing flexibility. ORA expects that SBC-CA will prove equally adept at exploiting any additional upward pricing flexibility for the good of its corporate bottom line. From the perspective of an SBC-CA customer, and relative to the overall good for the California economy, however, SBC-CA's proposal bodes ill indeed.

[168] SBC-CA Response to ORA 6-11, at RROIR 013970.

[169] SBC-CA Responses to ORA 6-1 and 6-2.

[170] SBC-CA Response to ORA 2-8.

Finally, the predecessor of the CPUC, the California Railroad Commission, was created to counteract the excesses of the Southern Pacific Railroad, which had a pricing policy generally summarized by historians and economists as "charging what the market would bear". The concept was premised on the notion that if a competitive market actually exists, a player in that market could not charge significantly above cost. SBC-CA has been able to raise rates, as noted in the preceding paragraphs, by hundreds of percent for the simple reason that it faces little or no competition for these services. If the CPUC does not acknowledge these facts, which are culled from SBC-CA's own data, and act accordingly to curtail ILEC pricing excesses, then it would fail to perform its historical function – to protect ratepayers from being charged what the market will bear.

VI. A REVIEW OF VERIZON-SPECIFIC EVIDENCE CONCERNING COMPETITION SUGGESTS THAT THERE IS LITTLE JUSTIFICATION FOR ALLOWING UPWARD PRICING FLEXIBILITY FOR CURRENT CATEGORY 2 SERVICES FOR MOST RESIDENTIAL AND SMALL BUSINESS CUSTOMERS.

A. Verizon-CA's Line Losses to Date Do Not Justify Significant New Upward Pricing Flexibility for Basic Exchange Services

Like SBC-CA, Verizon-CA opens its discussion of the competition it is supposedly facing with a recitation of facts about wireline losses starting in 2001.[171] Verizon-CA's ARMIS data do in fact show that its "switched access lines" declined from a peak of 4,775,383 in 2000 to 4,364,299 in 2004, for a total "loss" or 411,084 switched lines.[172] Switched access lines are, however, also only a portion of Verizon's product mix. As was the case for SBC-CA, Verizon-CA's "losses" of retail basic exchange services appear to be attributable primarily to shifting capacity among Verizon products, while Verizon's overall growth has been unabated.

For example, Verizon-CA's own data show that its total access line counts (switched and non-switched) have grown continually from 5.9 million in 2000 to nearly 7.4 million in

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[171] Opening Comments of Verizon-CA, Inc., 5/31/05, pp. 7-8; *see also*, Aron Decl., 5/31/05, p. 14.

[172] Exhibit 7 provides the source of all Verizon line counts and calculations discussed in the remainder of this section.

2004, contradicting its portrayal of significant line losses. Even this information provides an incomplete picture of how Verizon, as a whole, is faring in the face of competition. Over the same period, Verizon has gained hundreds of thousands of DSL broadband lines and millions of wireless connections in California, cannibalizing part of its own wireline product offering (quite possibly in a deliberate effort to move customers from lower to higher profit services). At the same time, Verizon's long-distance lines have rocketed to 17.7 million nationwide, capturing 47% of the customers in its ILEC footprint.

Verizon-CA's apparent loss of 411,000 retail switched access lines falls primarily into three categories: 198,000 "lost" business lines, 150,000 "lost" additional residential lines and 42,000 switched primary residential lines. Apparent losses, however, do not equate to actual losses by any means, as Verizon's own data reveal.

For example, Verizon-CA has not necessarily "lost" any business lines at all. Verizon's 2004 Annual Report vaguely attributes declining business lines to "competition and a shift to high-speed, high-volume special access lines."[173] The Verizon-CA line counts reveal that the shift from low-technology switched access lines to non-switched special access lines is more than sufficient to account for the entire reduction in Verizon-CA's switched business lines. Verizon-CA's ARMIS reports indicate that its non-switched line capacity in service actually grew from 1,166,801 voice-grade-equivalent lines in 2000 to 2,996,767 in 2004—a gain of over 1.8 million voice-grade-equivalent lines. Verizon-CA's growth in non-switched access lines swamps its supposed loss of switched access lines, resulting in a net gain of business line capacity of more than 1.6 million voice-grade-equivalent lines. Thus, some or all of the capacity that Verizon-CA formerly counted as switched lines may have simply shifted from switched to special access applications. This shift simply represents the continuation of a long-term trend.

Verizon-CA's data also suggest that, for the most part, it has merely shifted its 150,000 "lost" secondary residential lines to its (quite possibly more profitable) broadband services. As with SBC-CA, a substantial portion of Verizon-CA's reported switched line loss likely

[173] http://investor.verizon.com/financial/annual/2004/mda03.html.

represents the replacement of a second traditional voice line by a line-shared DSL service that uses a single line more efficiently (providing more capacity than the first and second line together previously did). Verizon as a whole may well be earning a higher profit from the single line that now provides multiple services than it did with two prior basic service lines—it has merely shifted a portion of its profits from Verizon-CA to an unregulated affiliate.

Verizon has also found that DSL, the likely substitute for a second line in many cases, *****BEGIN VERIZON "LAWYERS ONLY" CONFIDENTIAL** [174] **END CONFIDENTIAL***** Verizon-CA's advanced services affiliate has sold over *****BEGIN VERIZON CONFIDENTIAL END CONFIDENTIAL***** DSL lines in service in the Verizon-CA footprint. This factor alone would account for the apparent loss of non-primary residential lines several times over and would produce a net increase of over *****BEGIN VERIZON CONFIDENTIAL END CONFIDENTIAL***** lines. Again as with SBC-CA, Verizon-CA employees sell Verizon affiliate DSL service.[175]

Verizon-CA itself reports only a relatively insignificant loss of 42,000 retail primary residential lines, or only 2% of the 2.7 million lines it reported in 2000.[176] As with SBC-CA, some of Verizon-CA's loss of primary residential lines is likely attributable to Verizon's own efforts to market its wireless services. If Verizon were seriously concerned about wireline erosion, it would not use its Verizon-CA wireline company employees to sell Verizon wireless service, but Verizon admits that it does just that.[177] The obvious reason that it would do so is that Verizon, overall, is not harmed by the growth of wireless "competition." Most customers purchase wireless service in addition to wireline service. Relative to the few who "cut the cord," as one of the major providers of wireless service, Verizon stands a good chance of

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[174] A.05-04-020, Applicants' Response to TURN Request 3-24 in A05-04-020, at VZCA 00486269, permission to use granted in response to ORA 6-1.

[175] A.05-04-020, Applicants' Response to TURN Request 10-3.

[176] Unlike SBC-CA, Verizon-CA does include UNE-P in the lines it reports in the ARMIS 43-08 report. Verizon-CA Response to ORA 8-1. Hence, ORA is not adding back UNE line counts as was appropriate for SBC-CA.

[177] A.05-04-020, Applicants' Response to TURN Request 10-1.

supplying the replacement cord, perhaps with an improved profit margin. If even 1% of Verizon's California wireless customers are using that service in place of Verizon-CA primary wireline service, those additional Verizon wireless connections would *****BEGIN VERIZON CONFIDENTIAL END CONFIDENTIAL*****

Taken together, these facts concerning Verizon's line counts suggest that (on a total company basis) Verizon has ***gained*** over 2.1 million connections in California since 2000 when one factors in the migration that has occurred in the manner that services are delivered, even without taking into account its overall growth of wireless connections, *etc.*. Thus, instead of any significant competitive loss that compels regulatory relief, the data suggest that Verizon-CA and its affiliates have been growing at a solid pace if one considers how Verizon has been cannibalizing Verizon-CA's retail switched access lines.

B. Verizon-CA Retains a Dominant Market Share for Residential and Single-Line Business Basic Exchange Services

Using Verizon-CA's data concerning all facilities it provides to competitors (resale, UNE-P and UNE-L) and 911 records of all basic exchange service facilities provided by competitors themselves, ORA has compiled Verizon-CA's market share for both residential and business basic exchange services and has calculated the HHI for both of those "markets" as a whole.[178] ORA's analysis for Verizon-CA follows the same approach described above for SBC-CA.

Verizon-CA's data indicate that it currently provides about *****BEGIN VERIZON-CA CONFIDENTIAL END CONFIDENTIAL ***** of all residential basic exchange lines in its service territory. The HHI for this geographic and product market is 7,858, which is several

[178] The spreadsheets used to calculate Verizon-CA business and residential market share and HHI results discussed in this section are provided in Exhibit 8. Because the purpose of this analysis is to assess Verizon-CA's share of the markets for residential and business basic exchange services, ORA has excluded competitive loops utilized by Covad and New Edge, which are providers of broadband/data services instead of basic exchange service. Should the Commission wish to evaluate how ORA's market share and HHI results would change if these companies were included in the analysis, the first "tab" of Exhibit 8 includes a "trigger" that automatically includes results for these companies. Exhibit 8 also provides "triggers" that automate other sensitivity analysis, such as combining Verizon-CA and MCI retail lines and eliminating services that are provided entirely over Verizon-CA's facilities (resale and UNE-P).

multiples of the 1,800 threshold that the Department of Justice and Federal Trade Commission use to define "highly concentrated" markets.

Similarly, Verizon-CA currently provides about *****BEGIN VERIZON-CA CONFIDENTIAL END CONFIDENTIAL***** of all business basic exchange lines in its service territory. Combining this information with the shares of all other competitors produces an HHI of 5,643 for the single-line business basic exchange "market" in the Verizon-CA service territory. Although this figure indicates somewhat more competition than is the case for residential services, the HHI for business basic exchange services also far exceeds the 1,800 threshold for a "highly concentrated" market.

Verizon-CA's leading residential basic exchange competitors are: *****BEGIN VERIZON-CA CONFIDENTIAL END CONFIDENTIAL***** No other entrant has as much as a 1% share of residential basic exchange services.

Verizon-CA's leading business basic exchange service competitors are: *****BEGIN VERIZON-CA CONFIDENTIAL END CONFIDENTIAL***** No other entrant has as much as a 1% share of business basic exchange services.

Should Verizon consummate its merger with MCI, one of its leading competitors for basic exchange services, Verizon's share of residential basic exchange service would increase to *****BEGIN VERIZON-CA CONFIDENTIAL END CONFIDENTIAL*****, with an HHI of 8,399; its share of business basic exchange services share would increase to *****BEGIN VERIZON-CA CONFIDENTIAL END CONFIDENTIAL***,** with an HHI of 6,055.

Notably, the situation will worsen should SBC merge with AT&T, as the two companies seek to do. SBC currently does not compete outside of its franchise area for residential customers.[179] There is no reason to suspect that SBC will change its practice as a result of a merger with AT&T (unless it is ordered to do so as a merger condition). Thus, it is likely that most or all of AT&T's current share of the residential market (and perhaps the portion of its business market share that serves smaller businesses) will return to Verizon. This

[179] SBC-CA Response to ORA 10-8(a).

would boost Verizon-CA's share of residential basic exchange lines to *****BEGIN VERIZON-CA CONFIDENTIAL END CONFIDENTIAL*****

SBC currently competes with Verizon-CA to some degree for business customers. Completion of the SBC/AT&T merger (combined with completion of the Verizon/MCI merger) would increase the HHI for business basic exchange services in the Verizon-CA service territory from 6,055 to 6,085 as a result of combining SBC's and AT&T's market shares.

As ORA discussed above relative to SBC-CA, the longevity of competition based on resale and UNE-P is dubious, at best. Therefore, ORA also has computed what are essentially measures of wholesale market concentration that consider only facilities-based competition and include retail services provided using Verizon-CA facilities in Verizon-CA's market share. On this basis, Verizon-CA already has a *****BEGIN VERIZON-CA CONFIDENTIA END CONFIDENTIAL*****

C. Verizon's Internal Analyses Show the Company Is Holding Its Own against Competition

ORA's analysis is highly consistent with the limited market share data that Verizon provided in discovery. Verizon supplied a fourth quarter 2004 "Consumer Market Share" summary, dated April 2005. Relative to the residential market, it appears that Verizon's study data only considers Verizon-CA's Los Angeles service area. In that area, Verizon reports an *****BEGIN VERIZON "LAWYERS ONLY" CONFIDENTIAL** [180] [181] [182] **END CONFIDENTIAL*****

Other Verizon research affirms that Verizon-CA faces little, if any, competition for residential basic service outside of the Los Angeles area. In response to request identify major competitors other than wireless service providers (including Verizon itself), Verizon was unable to identify ***any*** competitors offering service that did not require a broadband connection

[180] Verizon Response to TURN 1-39, Attachment B.

[181] Verizon Response to TURN 1-39, Attachment C.

[182] *Ibid.*

in any of its California service areas other than Los Angeles (and in Los Angeles is identified only Comcast).[183]

ORA was unable to locate any internal Verizon analysis that would allow an HHI analysis relative to the residential market. For small ("mass market") business customers, the data in a third quarter 2004 Business Market Share Study are nearly sufficient to perform an HHI calculation.[184] That study provides small business share for both Los Angeles and California as a whole. For Los Angeles, Verizon's small business market share data indicate an HHI of *****BEGIN VERIZON FCC HIGHLY CONFIDENTIAL (SUBJECT TO SECOND PROTECTIVE ORDER)** [185] [186] **END CONFIDENTIAL***** Verizon's internal data also suggest that the overall pace of competition in Verizon's California service area *****BEGIN VERIZON "LAWYERS ONLY" CONFIDENTIAL** [187] [188] [189] [190]

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[193] [194] **END CONFIDENTIAL*****

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[183] Verizon-CA Response to Cox 1-34.

[184] Verizon FCC Production in A.05-04-020, VZCA 00407774, permission to use granted in response to ORA 6-1.

[185] *Ibid.*, at VZCA 00407794.

[186] *Ibid.*, at VZCA 00407796.

[187] *See* ORA workpaper summarizing Verizon's weekly "CLEWS" data as provided in A.05-04-020 in Verizon Response to TURN 11-3, permission to use granted Verizon Response to ORA 6-1 ("ORA CLEWS workpaper").

[188] *Ibid.*

[189] *Ibid.*

[190] Verizon Response to TURN Request 3-51 from A.05-04-020, at VZCA 00487164, permission to use granted in response to ORA 6-1.

[191] Verizon Response to TURN Request 5-10 in A.05-04-020, permission to use granted in response to ORA 6-1.

[192] ORA CLEWS Workpaper.

For small "mass market" business customers, Verizon's data for its entire Verizon "West" region (former GTE areas) confirm that Verizon did not experience *****BEGIN VERIZON FCC HIGHLY CONFIDENTIAL (SUBJECT TO SECOND PROTECTIVE ORDER)** [195] **END CONFIDENTIAL*****

Indeed, in its internal analyses of its competitive position nationwide, Verizon observes that its *****BEGIN VERIZON FCC HIGHLY CONFIDENTIAL (SUBJECT TO SECOND PROTECTIVE ORDER) AND "LAWYERS ONLY" CONFIDENTIAL** [196] **END CONFIDENTIAL** Thus, there is no sign that Verizon is a company experiencing difficulty holding its own against competition, and there are many signs that it may actually be beginning to beat back whatever competition existing in recent years—particularly for residential and small business customers.

D. Competition Is Not Uniformly Distributed throughout the Verizon-CA Service Territory

Verizon's weekly CLEWS reports suggest that *****BEGIN VERIZON FCC HIGHLY CONFIDENTIAL (SUBJECT TO SECOND PROTECTIVE ORDER)** [197] **END CONFIDENTIAL*****

ORA's analysis of Verizon data concerning lines provided to competitors and E911 records (see Exhibit 8) also finds a significant variance in the level of market concentration by

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[193] Verizon Response to TURN Request 11-2 in A.05-04-020, at VZCA 00493843, permission to use granted in response to ORA 7-8.

[194] Verizon Response to TURN Request 3-51 from A.05-04-020, at VZCA 00487165, permission to use granted in response to ORA 6-1.

[195] Verizon FCC Production in A.05-04-020, Verizon Market Research, Business Market Share Study, 3Q 2004 Results for the SMB Market, VZCA 00407774, at VZCA 00407786 and 00407789, permission to use granted in response to ORA 6-1.

[196] Verizon FCC production in A.05-04-020, VZCA 00079352, at VZCA 00079353, permission to use granted in response to ORA 6-1.

[197] Verizon FCC production in A.05-04-020, VZCA 00409875, at VZCA 00409877, permission to use granted in response to ORA 7-8.

wire center.[198] Relative to residential basic exchange service, *****BEGIN VERIZON CONFIDENTIAL   END CONFIDENTIAL***** Even the low end of this distribution reflects highly concentrated markets.

Relative to business basic exchange service, *****BEGIN VERIZON CONFIDENTIAL   END CONFIDENTIAL***** Again, even the low end of this distribution reflects highly concentrated markets.

Although the HHI result for each of these wire centers indicates a highly concentrated market, the results also exhibit a significant range, which confirms that competition is not developing evenly throughout Verizon-CA's service area.

E. Verizon-CA's Behavior and Internal Documents Suggest that It Will Exploit the Absence of Regulatory Constraints in Ways that Disadvantage Many California Consumers

As with SBC-CA, Verizon-CA's exercise of pricing flexibility for its residential inside wire maintenance service provides a cautionary example of the dangers of premature deregulation while an incumbent retains significant market power. Piggybacking on SBC-CA, Verizon-CA applied to have its inside wire maintenance plan reclassified from Category 2 to 3 in February 2002. The Commission granted Verizon-CA reclassification and a request for an initial rate increase from \$0.95 to \$1.75 in May 2004.[199] At that time the Commission capped Verizon-CA's rate at \$1.75 for one year and at \$2.99 thereafter (just as it found that it needed to do for SBC-CA).[200] Like SBC-CA, as soon as it was able, Verizon-CA raised its rate to the \$2.99 maximum.[201]

Moreover, it appears that Verizon has contemplated or is implementing a strategy to *****BEGIN VERIZON HIGHLY CONFIDENTIAL (SUBJECT TO SECOND**

[198] ORA's analysis of wire-center specific results includes the E911 records that Verizon was able to associate with specific wire centers, which includes a large portion of E911 records (but also omits many).

[199] D.04-05-058, pp. 1-3.

[200] *Ibid.*

[201] Verizon Advice Letter No. 11,148, 4/26/05.

PROTECTIVE ORDER IN FCC WC DOCKET NO. 05-75) [202] [203] [204] [205] **END CONFIDENTIAL***** Such business practices may be consistent with the behavior of firms in unregulated markets, but they also suggest that the Commission cannot rely on Verizon-CA's unregulated investment decisions to ensure that all California consumers have access to modern infrastructure.

Thus, given the lack of competition in the Verizon-CA service territory that ORA has demonstrated above and Verizon-CA's own behavior in the absence of regulatory constraints, ORA urges the Commission to refrain from granting Verizon-CA significant additional upward pricing flexibility at this time. The downward pricing flexibility ORA recommends will allow Verizon-CA to respond to competition where it does exist without permitting the company to exploit captive ratepayers to fund its competitive forays.

VII. IT IS PREMATURE TO ADOPT ANY SIGNIFICANT RELAXATION OF REGULATION FOR SUREWEST AND FRONTIER.

SureWest and Frontier, the two mid-sized ILEC Respondents to the OIR, both seek effective deregulation of all their retail services other than primary residential basic exchange lines.[206] Thus, they propose a "uniform" regulatory framework that is even more aggressively deregulatory than that sought by Verizon-CA or even, in some respects, SBC-CA.

It is far from clear that SureWest and Frontier should be subject to the same regulations as are SBC-CA and Verizon-CA. Before considering how to implement a uniform regulatory framework that includes SureWest and Frontier, the Commission should first develop some concrete record concerning how and why the regulatory environment differs between those companies and SBC-CA and/or Verizon-CA today.

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[202] Verizon FCC production, Market Categorization Proposed Workplan, March 2004, VZCA 00317025- VZCA 00317037, at VZCA 00317026.

[203] *Ibid.*, at VZCA 00317027.

[204] *Ibid.*, at VZCA 00317029.

[205] *Ibid.*, at VZCA 00317030.

[206] SureWest Opening Comments, 5/31/05, pp. 18-19; Frontier Opening Comments, 5/31/05, p. 2. [CITES]

As SureWest itself points out, one very obvious difference is that SureWest and Frontier are vastly smaller companies than the two major California ILECs.[207] In consideration of that fact, regulators have traditionally treated SureWest and Frontier differently from the largest ILECs. As mid-sized carriers, Surewest and Frontier have already received significant relief from FCC accounting and reporting rules.[208] Section 11 of the Communications Act of 1934 requires that the FCC review every two years whether its regulations that are "no longer necessary in the public interest as the result of meaningful economic competition between providers of telecommunications service. Thus every two years, the FCC proposes simplification of its accounting rules, seeks comments and then Orders upon reduced reporting requirements. In FCC's last Order[209], it significantly reduced the scope of ARMIS reporting required of "mid-sized carriers", which include all incumbent LECs whose operating revenue equals or exceeds the indexed revenue threshold (then $117 million) and whose revenue when aggregated with the revenues of any LEC that it controls, is controlled by, or with which it is under common control is less than $7 billion.

Their comparatively small size has conferred competitive advantages on these two ILECs as well. For example, Frontier was never required to provide UNE-P and thus has been bypassed by what was heretofore the main source of competition for SBC-CA and Verizon-CA.[210] Although SureWest did have to offer UNEs at Commission-arbitrated prices to at least one competitor (Covad), it also managed to avoid a full-fledged onslaught from UNE-P competitors such as AT&T and MCI. Indeed, as discussed below, the data that ORA has obtained from SureWest and Frontier indicate that vigorous competition for the mid-sized ILECs remains little more that a prediction of the ILECs themselves.

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[207] Opening Comments of SureWest Telephone (SureWest Comments"), 5/31/05, p. 2.

[208] See, for example, FCC REPORT AND ORDER IN CC DOCKET NOS. 00-199, 97-212, AND 80-286, FURTHER NOTICE OF PROPOSED RULEMAKING IN CC DOCKET NOS. 00-199, 99-301, AND 80-286, Adopted: October 11, 2001, FCC 01-305.

[209] Id., at pp. 51 through 73.

[210] Frontier Response to ORA 2-23.

Therefore, the CPUC should not and need not rush to offer SureWest and Frontier additional regulatory freedom, even if it decides that SBC-CA and Verizon-CA face sufficient competition to justify further deregulation. Regardless of how the CPUC decides to regulate SBC-CA and Verizon-CA, the CPUC should retain existing price caps for all SureWest and Frontier services (with the possible exception of secondary residential lines) until such time as SureWest and Frontier demonstrate that there is meaningful competition within their service territories.

A. SureWest

SureWest itself reminds the CPUC that its existing regulatory framework was developed after the CPUC "heard and considered many predictions of vigorous future competition," but determined that "it is not prudent to base today's policies as if all these predictions [of competition] were certain to come true."[211] In the current proceeding, SureWest claims that it faces "actual or potential competition from many existing and emerging service providers, including: long distance carriers, CLECs, wireless carriers, cable providers, satellite providers, Internet service providers, broadband-over-powerline companies, and, perhaps most significantly, Voice over Internet Protocol ('VoIP') providers."[212] Yet, SureWest claims not to have any actual data concerning its market share.[213] Hence, SureWest's current case appears to be little more than the same empty prediction of future competition that it offered the CPUC a decade ago.

As one example, SureWest reports that it has lost a total of approximately 15.3% of business lines in its territory, which would leave it with an extremely concentrated 84.7%

[211] SureWest Comments, p. 3, quoting D.96-12-074.

[212] SureWest Comments, 5/31/05, p. 2.

[213] SureWest Responses to ORA 2-4 to 2-7.

share.[214] SureWest's source data for this claim, however, reveal that *****BEGIN SUREWEST CONFIDENTIAL** [215] **END CONFIDENTIAL*****

Moreover, SureWest's data also indicate that the recent pace of competition remains slow. The total ported lines increased from 3,535 in 2002 to only 4,672 at the end of April 2004.[216] This increase of 1,137 ported lines in more than a year suggests an annual rate of capture by facilities-based entry of less than 1% of SureWest's total lines.[217]

Equally important, although SureWest discussed in detail the threats it supposedly faces from wireless, cable and broadband competitors, it chooses not to dwell on its own significant gains in those areas.[218] As with other incumbents, SureWest's reported line losses appear to be largely the result of its *****BEGIN SUREWEST CONFIDENTIAL** [219] [220] **END CONFIDENTIAL*****

Indeed, SureWest's successes beyond basic wireline service provide an intriguing hint that aspects of the existing NRF framework may be working very well. Under NRF, SureWest has expanded and apparently flourished in long distance, wireless, data and television services.[221] According to its latest Form 10-Q, from June 2004 to June 2005, SureWest lost 4,072 (3%) of its total wireline ILEC access lines.[222] But, over that same period, it gained

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[214] SureWest Comments, p. 5.

[215] SureWest Response to ORA 3-1. attachment.

[216] SureWest Comments, p. 5.

[217] SureWest Communications, Form 10-Q, for the quarterly period ended June 30, 2005, Part I, Item 2, p. 17.

[218] SureWest Comments, pp. 10-13.

[219] SureWest Response to ORA 3-1, attachment.

[220] *Ibid.*

[221] SureWest Response to ORA 2-22.

[222] SureWest Communications, Form 10-Q, for the quarterly period ended June 30, 2005, Part I, Item 2, p. 17.

5,412 long distance customers (up to 50,094, making a 12% increase for the year), 2,976 DSL customers (up to 23,861, making a 14% increase for the year), 4,343 fiber-to-the-premises customers (up to 18,057, making a 32% increase for the year) and 4,830 wireless customers (up to 53,361, making a 10% increase for the year).[223] Notably, SureWest explains that each fiber-to-the premises service can support multiple services such as "digital video, voice and data," each of which it counts as a separate "revenue-generating unit."[224] SureWest reports that its total 18,057 fiber-to-the-premises connections resulted in a total of 42,255 "revenue-generating units" for SureWest, which suggests that each new fiber-to-the-premises customer is actually subscribing to 2.34 new services from SureWest, one of which may be voice telephone service.[225] Therefore, it appears that SureWest may be hiding significant growth in voice telephone service (albeit much of that growth may be out of its franchise area) by reporting service growth as an additional "revenue-generating unit" associated with fiber-to-the-premises instead of access line growth.

In combination with SureWest's substantial gains on other fronts, it is plain that the company is growing rapidly despite any existing competition. Moreover, SureWest's claims suggest that it has been investing in its network under NRF. In addition to developing its own wireless operations, SureWest claims that its wireline network has already been upgraded so that 100 percent of its customers have access to DSL (which beats either SBC-CA or Verizon).[226]

As noted above, SureWest also already offers fiber-to-the-home facilities serving over 18,000 customers and is competing for those residential customers outside of its monopoly franchise. Thus, to the degree that the goals of a sound regulatory framework include providing an incentive for investment and the delivery of advanced services, it would appear

[223] *Ibid.*

[224] *Ibid.*

[225] *Ibid.*

[226] www.surw.com/about/

that the existing framework is doing a very fine job at least as far as SureWest is concerned. Of course, this may also indicate that, to at least some degree, the existing NRF framework does not do enough to monitor and control SureWest's earnings.

B. Frontier

Frontier's comments include very little content other than Frontier's wish list of regulatory changes. Humorously, Frontier states that "Frontier's comments demonstrate that it faces substantial competitive pressures in its service area."[227] It is difficult to fathom how Frontier imagines it "demonstrated" any such thing as Frontier does not present a single fact concerning competition in its service area or even mention a single actual competitor anywhere in its comments. Moreover, Frontier admits that it does not possess a single page of workpaper supporting its comments, which are entirely "conceptual in nature and represent Frontier's policy position."[228] Frontier also confirms that it has created or reviewed any study in the last 19 months regarding what its market share might be.[229] Hence, what Frontier apparently means is that it has demonstrated that its policy position is that it faces substantial competition.

The available data do not support Frontier's policy position. Frontier reports an overall change in basic service lines from *****BEGIN FRONTIER CONFIDENTIAL** [230] [231] **END CONFIDENTIAL*****

Frontier also reports that, from 2003 to year-to-date 2005, *****BEGIN FRONTIER CONFIDENTIAL** [232] [233] [234] **END CONFIDENTIAL***** Frontier reports that 90% of its

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[227] Opening Comments of Citizens Telecommunications of California, Inc. d/b/a/ Frontier Communications of California ("Frontier Comments"), 5/31/05, p. 4.

[228] Frontier Response to ORA 3-1.

[229] Frontier Responses to ORA 2-4 through 2-7.

[230] Calculations based on Frontier Response to TURN 1.3.

[231] Frontier Response to TURN 1.31.

[232] Frontier Response to TURN Set 1 with ORA calculations added, included in Exhibit 4.

[233] *Ibid.*

customers currently have access to its broadband service,[235] which simultaneously demonstrates that the Commission's existing regulatory framework has not deterred Frontier from upgrading its network and that Frontier is well-positioned to continue cannibalizing its intrastate regulated services using its own broadband facilities.

VIII. TIMING IS EVERYTHING—AND THE TIME IS WRONG FOR NEAR-TOTAL PRICE DEREGULATION OF BASIC LOCAL EXCHANGE SERVICES

The Commission's June 27, 2005 full panel hearing in this proceeding featured a presentation by Professor John M. de Figueiredo, co-author with Charles H. Fine of a paper entitled "Can We Avoid Repeating the Mistakes of the Past in Telecommunications Regulatory Reform?" Based on their analysis of five industries (railroads, natural gas, banking, airlines and mobile telephony[236]), Professors Fine and de Figueiredo suggest that, ***where strong competitive conditions existed,*** piecemeal deregulation has produced less desirable results that swift, timely and relatively complete deregulation. At the full panel hearing, however, Professor de Figueiredo stopped short of concluding that California's intrastate telecommunications markets are ripe for such sweeping deregulation.[237] He deferred to others for a specific analysis of competition conditions in California.

In these reply comments, ORA has provided precisely that analysis for each of the four largest California incumbents. The results show that ***none*** of these four companies faces the kind of pervasive competition that existed in the industries studied by Professors Fine and de Figueiredo. Instead, all four Respondents hold extremely dominant positions in the markets for residential and business local exchange services, and the behavior of the two largest incumbents when granted upward pricing flexibility under the existing regulatory framework

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[234] *Ibid.*

[235] Frontier Response to TURN 2.13.

[236] Professors Fine and deFigueiredo have not studied the electricity industry. 6/27/05 Full Panel Hearing Tr. at 16. Had they done so, ORA suspects they might have identified more than a theoretical possibility that deregulation can happen too soon. *Cf.* Tr. at 15.

[237] *Ibid.* at 11.

strongly suggests that competitive market forces are insufficient to constrain their pricing behavior.

Further, Professor de Figueiredo himself acknowledged that the telecommunications markets exhibit a more complex ownership structure than the industries he and Professor Fine studied—a structure in which the incumbents own some of their intermodal "competitors."[238] ORA has demonstrated here that the ownership structure is even more complex than Professor de Figueiredo realized. Not only do the incumbents own some of the largest wireless competitors, they also own advanced services affiliates that provide DSL services in "competition" with ILEC-provided switched access line services. Further, they provide bottleneck special access facilities to unaffiliated wireless competitors ***and*** control one of the two major forms of broadband access by which "pure-play" or stand-alone VoIP providers can offer voice services in competition with the ILECs' wireline services. Tying arrangements between affiliate DSL services and the ILECs' retail voice services (*i.e.*, the lack of so-called "naked DSL") are part of the problem here, but even without such tying arrangements, the parent companies of the Respondents still would control this important means of broadband access and could price that access in a way that renders voice competition from stand-alone VoIP providers uneconomic.

Thus, there is little danger that a failure to permit full deregulation of California's intrastate telecommunications markets today would result in the kind of collapse of the incumbents that occurred when deregulation of the railroad industry was delayed ***more than two decades*** after the onset of effective intermodal competition from the trucking industry. Nor is there any reason to expect that full deregulation of the Respondents would produce the kind of significant price reductions that followed airline deregulation. (Indeed, the CPUC should recall that airline regulation set ***minimum*** prices, not maximum prices, so it is hardly surprising that prices fell after the artificial price floors were eliminated. One cannot expect a similar result from eliminating regulated price ***ceilings*** for intrastate telecommunications services.)

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[238] *Ibid.* at 29.

ORA does agree with Professor de Figueiredo that "[i]t's about timing. You've got to find the right time."[239] The problem is that today is ***not the right time*** to permit the Respondents any significant new upward pricing flexibility. The weight of the evidence suggests that competition will not constrain their prices (at least for primary residential and single-line business basic exchange services) and that the incumbents will not restrain themselves from exploiting every bit of regulatory freedom granted to raise prices to captive customers. Furthermore, it is unreasonable to grant the Respondents unlimited upward pricing flexibility for services for which they receive hundreds of millions of dollars in subsidies designed to keep service affordable. Unless and until the CPUC addresses reform of the various intrastate programs that subsidize the Respondents' services, it should retain price caps over the services that are subsidized.

The time is, however, ripe for reforms that allow more ***downward*** pricing flexibility and get the CPUC out of the business of policing anti-competitive behavior. Thus, as described in Section II above, ORA recommends the elimination of CPUC-established price floors for ***all*** services and CPUC-imposed restrictions on promotions, other than informational requirements. Even these reforms, however, should be undertaken with caution, lest nascent intermodal competition be stamped out.

Finally, ORA observes that getting the timing right requires better information about competitive market conditions than is readily available to the CPUC. In particular, the CPUC needs granular detail that gives better insight into where competition is emerging and for which customers. Thus, either in workshops or in Phase 2 of this proceeding, ORA urges the CPUC to develop new reporting requirements that would collect timely and focused information relating to competition in California. Such information, combined with other streamlined and target monitoring data, will permit the CPUC to continue finding the "just right" balance between regulatory oversight and unhindered operation of free markets.

[239] *Ibid.* at 25.

IX. CONCLUSION

For all of the reasons discussed above and in ORA's May 31st comments, ORA recommends that the CPUC adopt the proposal outlined in Section III of these reply comments and reject the Respondents' unjustified recommendations for even further deregulation of intrastate telecommunications services.

Respectfully submitted,

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September 2, 2005

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of **"REPLY COMMENTS OF THE OFFICE OF RATEPAYER ADVOCATES"** in **R.05-04-005** by using the following service:

[**X**] **E-Mail Service:** sending the entire document as an attachment to an e-mail message to all known parties of record to this proceeding who provided electronic mail addresses.

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Executed on the 2nd day of September, 2005 at San Francisco, California.

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Perrine D. Salariosa

N O T I C E

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